Republic of Serbia
Fiscal Council

# PROPOSED FISCAL CONSOLIDATION MEASURES FOR 2012-2016

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## Content

## Introduction

The Fiscal Council is an independent government body reporting to the National Parliament of the Republic of Serbia. Article 92z of the Budget System Law states that the Fiscal Council may give advice to the Government at any point, on the Council's own initiative or upon request, about any issues relating to fiscal policy and management of the public finances.

Because the public debt of the Republic of Serbia exceeded the legal ceiling of 45 percent of GDP at the end of 2011, the Government is obliged (Budget System Law, Article 27e) to submit a program to reduce public debt. The Fiscal Council is of the opinion that it should recommend directions and economic policy measures that will curb the growth of Serbian public debt and avoid a debt crisis.

Milojko Arsić and Saša Ranđelović from the Faculty of Economics in Belgrade have made significant contributions to the preparation of this Fiscal Council document, "Proposed Fiscal Consolidation Measures for 2012–2016" and Professors Ljubomir Madžar and Diana Dragutinović provided valuable suggestions on a preliminary version of this document. All responsibility for the estimates and views presented remains with the Fiscal Council.

## PREFACE

Serbia is heading towards a public debt crisis, which may break out by the end of 2012. Immediate measures must be taken, first to avert the crisis and then to repair the public finances. The fiscal consolidation program outlined in this document proposes measures for 2012 and 2013 to solve immediate problems and a program of reforms to consolidate public finances in the medium term (2014–2016) by bringing down public debt significantly and reducing the government deficit until it is close to zero. Because the cuts must be large and will be painful, the program envisages that the burden of fiscal consolidation will to the extent possible be equally distributed, but with protections for the most vulnerable members of the population. The proposed fiscal consolidation, along with the structural reforms of the Serbian economy that are necessary, will build the foundation for future sustainable economic growth.

The fiscal deficit and public debt have been burgeoning throughout 2012; by the end of this year the deficit may easily exceed 6 percent of GDP and public debt may equal 55 percent. That kind of trajectory inevitably leads to a public debt crisis, which would be manifested in Serbia by a plunge in the dinar and rising inflation on the one hand and decreasing output and rising unemployment on the other. Immediate tough measures are therefore necessary to prevent the crisis.

The deficit and rising public debt are only partly consequences of the stagnation of the Serbian economy and the consequent lower tax revenues. Even if economic growth were normal, Serbia would still record a fiscal deficit (the “structural deficit”) of 4–5 percent of GDP, which would survive even after the economy emerges from stagnation. The deficit is in fact a symptom, the most obvious symptom, of the poor state of Serbia’s public finances. It also indicates the cutting that will be needed—4–5 percent of GDP—to eliminate the structural deficit. That will require serious medium-term reforms.

The magnitude of both the short-term (2012–2013) and medium-term (2014–2016) adjustments that are necessary demands serious measures, first in terms of reining in expenses, but also in terms of tax reform. The fiscal consolidation proposed in this document envisages a 4:1 ratio of lowered expenditures to increased revenues. International experience has demonstrated that permanent recovery of public finances is achieved first and foremost by decreasing expenditures. It is, moreover, abundantly clear that public spending in Serbia is higher than in any comparable country.

Therefore, the Council program emphasizes not only decreases in public expenditures relative to GDP but also changes in the structure of public spending, which is equally important. With the proposed cuts, however, we are proposing significant growth of public investment in infrastructure. This is necessary both to lay the foundation for medium-term economic growth and also to stimulate economic activity this year and next.

Providing room for the necessary growth in public investments implies the need for a drastic decrease in current expenditures. There are no easy, painless solutions; the reforms must be serious and the measures tough. Because the major share of public expenditures goes to salaries and pensions, these segments will have to provide the most adjustment. Serbia is spending more on salaries and pensions than the economy can afford, and certainly much more than comparable countries. If the public finances are to recover, spending in this area must be brought down to a level the economy can sustain. Salaries and pensions will have to be frozen in 2012 and 2013, and these sectors must be reformed to provide for further (relative, not absolute) decrease. Among other measures, reforms imply fewer employees in the public sector, penalties for early retirement, and raising the retirement age for women.

Reform of the subsidies policy is the next priority for bringing spending down. At the moment, subsidies abound, and because they are mostly not targeted, they have no economic justification. We propose that some be immediately annulled and others decreased or redefined.

Lurking behind the high subsidies there is also the difficult issue of restructuring or privatizing state-owned enterprises. So far, reform of public enterprises, both local and national, has always hit the insurmountable wall of politics. The enterprises that need restructuring "employ" 97,000 people, and they are actually spending a generous amount of direct and indirect subsidies—a huge burden on the shoulders of the Serbian economy that the new Government and the Ministry of Economy must deal with. There should be a firm deadline, no more than two years, by which state enterprises will either be restructured, privatized or liquidated.

Still to be considered in terms of consolidating spending is the important project of adopting a sustainable model of fiscal decentralization, which is drastically compromised by amendments passed to the relevant law in June 2011. Besides establishing a rational, efficient, and sustainable system, the solutions we on the Fiscal Council propose should also ensure the necessary savings. Public expenditures for goods and services would also be reduced by improving public procurement, reducing corruption, and curbing the informal economy, which requires among other things reform of tax administration. Finally, we propose that a number of state agencies, off-budget funds, and similar institutions be reformed or eliminated to achieve both savings and efficiency gains. Curbing the informal economy and making public procurement more efficient would produce relatively high savings, particularly in the medium term. These efforts are an important component of fiscal consolidation, but getting them done does not in any way imply that a tax increase and a wage and pension freeze can be avoided. Though their bottom-line importance is relatively modest, the savings generated by eliminating agencies, off-budget funds, and similar institutions are useful primarily as a signal about the priority of cutting unproductive spending.

The tax reform that we propose has two main goals: first, to change the structure of revenues by shifting the tax burden from labor to consumption, and second, to prevent a fall in tax revenues relative to GDP. Tax reform as a response to a crisis in public finances has been undertaken by many countries, among them Germany, Hungary, France, and Croatia. A major motivation was to make their economies more competitive internationally and thus stimulate their exports by fiscal depreciation, lowering unit labor costs. On the other hand, increased taxes on consumption slow it down, with a consequent decrease in imports. Both help to turn the drivers of economic growth, as is necessary, from consumption and imports to exports and investment.

A corollary of moving to economic growth driven by exports and investments is that if tax rates are unchanged, tax revenues fall because revenues decline as the VAT base (consumption and imports) narrows. We therefore propose a tax reform that will provide additional revenues of 1 percent of GDP and thus prevent a relative (compared to GDP) decrease in public revenues. To put it another way, the proposed tax reform ensures that the share of public revenues in GDP is unchanged through 2016, at the level of about 40 percent. This means that the tax burden (40 percent of GDP) would remain unchanged even though tax rates increase, though of course the distribution of the burden will shift significantly, from those who invest and export to those who spend and import. Finally, if it is to effectively reduce the deficit and public debt, tax reform should be immediate.

The proposed program of fiscal consolidation is one of the cornerstones of Serbia's future economic growth, another being structural reforms, which are not considered here.[1] Fiscal consolidation guards against a decrease in production and employment because it prevents crises. That effect obviously comes at a price: in the short term (2012–2013), the proposed austerity measures will dampen economic growth moderately, though we nevertheless expect growth of at least 2 percent in 2013 (assuming there is no new crisis in the European Union). In the medium term (2014–2016), however, consolidation will promote economic growth in several ways:

1. First is the anticipated increase in public investment in infrastructure. This investment should help stimulate economic activity as soon as 2012 and 2013 and thus partly offset the negative effect of the proposed spending cuts and tax increase. After that, the infrastructure built will in turn stimulate private investment and economic growth.
2. Fiscal consolidation will promote growth by bringing down interest rates on corporate and government borrowing and attracting foreign capital, including foreign direct investment. Sustainable public finances—low public debt and a low deficit—are crucial for economic stability and thus also for bringing in capital.

The fiscal consolidation program proposed in this document is similar to programs implemented or announced by other countries facing similar challenges. Some are countries more advanced than Serbia, such as Slovenia and Croatia, but others, such as Romania and Latvia, are more like us. Our program is closer to the programs of the former group, because Romania and Latvia were forced to take much tougher measures: a significant wage and pension cut and downsizing in the public sector.

Pavle Petrović,
Chairman, Fiscal Council of the Republic of Serbia

[1] One structural reform programme is presented in the World Bank document (2011), "Serbia – Country Economic Memorandum: The Road to Prosperity: Productivity and Exports."

## SUMMARY

***Public finances in Serbia are on an unsustainable path.*** At the end of 2011, public debt exceeded the legal limit of 45 percent of GDP and will continue rising in 2012 and 2013. The main driver of this trend is the fiscal deficit, which in 2012 will be significantly higher than the RSD 152 billion that was planned, since it already surpassed that by RSD 30 billion in the first quarter alone. If nothing is done, by year-end we expect that the 2012 fiscal deficit will be more than RSD 200 billion, and public debt will be about 55 percent of GDP. Among other unfavorable aspects of the environment for public finance in Serbia is the fact that instead of expected GDP growth of 1.5 percent, it will probably stagnate this year, and if the EU crisis deepens, economic activity may even decrease. Real depreciation of dinar, as happened in the first half of this year, further increases the share of public debt in GDP, since more than 80 percent of the debt is denominated in euros and U.S. dollars while GDP is denominated in dinars. That is why it is necessary, as soon as the Government is formed, to promptly undertake tough measures to bring the fiscal deficit down; prepare a credible plan for mid-term reforms to permanently decrease public spending; and cut back on issuing state guarantees, since they also increase public debt. In "Proposed Fiscal Consolidation Measures for 2012–2016," the Fiscal Council identifies and analyses all these topics and offers the executive branch recommendations for both short-term measures for fiscal consolidation and structural reforms to help return public finances in Serbia to a sustainable path and ensure a firm foundation for high economic growth.

***There is a threat of a public debt crisis.*** From 2008 through 2011, Serbia's public debt increased by about €5.7 billion, bringing it up from about 29 percent of GDP to about 49 percent. By the end of 2012, public debt will rise above 50 percent of GDP; if that happens, Serbia, like similar countries, is likely to have a public debt crisis. Such a crisis occurs when investors believe that a country can no longer service its debt, so they stop buying its bonds (see Chapter 2: "The Sustainability of Serbia's Public Debt").

***Serbia is currently very dependent on new borrowing.*** By the end of this year, Serbia will need another € 2.5 billion to finance the deficit and pay off the principal of previous loans. If at some point investors loss confidence in its solvency, Serbia would not be able to find resources to finance basic obligations and would be well along on the road to crisis. Whether investors stay confident depends on whether the economic fundamentals show an improvement in public finance trends; so far that is not the case for Serbia, though there is still time for decisive Government action and a credible plan of measures to ensure that the state stays solvent and can pay its debts.

***By the end of 2012 the deficit will surpass RSD 200 billion if nothing is done,*** mainly driven by public debt. In the first two years of the global financial crisis, Serbia's deficit was a bit lower than the EU average. However, starting in 2010 most EU member states brought their deficits down drastically, mostly by increasing taxes, while in Serbia the deficit remained at about the same level as in 2009, 4.5–5.0 percent of GDP. In 2012, the situation worsened. Data from the first quarter, when the deficit projection for the year was already surpassed by about RSD 30 billion, and preliminary data for April showed that the general government deficit had shot up. By the end of the year, unless firm measures to control it are taken, we estimate that instead of the projected RSD 152 billion, the deficit could surpass RSD 200 billion—more than 6 percent of GDP.

***The deficit is increasing due to both lower public revenues and unrestrained public spending.*** In December the Fiscal Council was alerted to the possibility that the deficit would be higher than expected. The Council's preliminary evaluation in December took into account the expectation that public revenues would be lower than budgeted, making the 2012 deficit higher. Public revenues were expected to be lower because economic growth in 2012 had been estimated at 1.5 percent but by December was expected to be 0 percent; and because projections for revenues had been too optimistic even if GDP growth of 1.5 percent had been achieved. In the meantime, moreover, public spending, which we had expected on current trends to be about RSD 25 billion for the year, had gone up. Unless something is done promptly to cut it, we estimate that the deficit in 2012 will be about RSD 55 billion higher than projected. This is clearly unsustainable.

***The new Government must therefore move immediately and forcefully to bring the deficit down for this year and next.*** The Fiscal Council evaluation is that for the short-term sustainability of public finances and to avoid a public debt crisis, the deficit must be sliced from the present 6.2 GDP to 3 percent in 2013—a decrease of about €1 billion. To accomplish this, the Fiscal Council recommends that the new Government move promptly in three areas:

1. **Tax reform.** The Council proposes a two-phase tax reform: In the first phase, to be undertaken immediately after the new Government is formed, both the VAT rates would go up, the higher from 18 to 22 percent and the lower from 8 to 10 percent. Also, nonessential products would be transferred from the lower to the higher tax bracket and excise taxes would go up for tobacco and alcoholic beverages. These changes would bring in about 0.9 percent of GDP in additional tax revenues in 2012, and the deficit would be decreased by that amount (€270 million). In the second phase, starting in January 1, 2013, we propose lowering the fiscal burden on labor by decreasing taxes and contributions from the employer from 17.9 percent to 10 percent of gross earnings, which would relieve the fiscal burden on labor from 64 percent to 54 percent for employees with an average salary and about 45 percent for minimum-wage employees; restricting and limiting certain fees; abolishing exemptions and deductions within the corporate income tax; and improving the legal structure related to property tax and its collection. The net effect of both phases would be a permanent increase in the tax revenue share in GDP of about 1 percent of GDP and would keep the share in GDP unchanged until 2016 (see Chapter 12: "Tax System Reform"). The standpoint of the Fiscal Council, which is economically justified, is to make most of the necessary fiscal adjustments by decreasing public spending rather than increasing revenues. Therefore we propose that the share of public revenues in GDP should not be increased by more than 1 percent of GDP, short- or mid-term.
2. **Freezing public pensions and salaries.** Pensions and salaries would remain frozen throughout 2012 and 2013. This would ensure that in 2013 the share of the wage bill and pensions in GDP would decrease, as is necessary, by about 1 percentage point and would thus bring the deficit down by the same amount (€300 million). Besides the obvious savings, freezing pensions and salaries would have another economic justification because the main reason the public spending structure in Serbia is much worse than in similar countries is that it spends much more on pensions and salaries. Public and state salaries in Serbia are also significantly higher than in the private sector, and the ratio between average salary and pension in Serbia is among the highest in Europe.
3. **Putting in place a sustainable system of fiscal decentralization.** The amendments to the Law on Local Self-Government passed in June 2011 have created an imbalance between the revenues and liabilities of different levels of government that has almost totally eroded Serbia's public finances. The Fiscal Council proposes a complete withdrawal or at least a significant modification of the amendments; for instance, one modification could be adoption of a more just system of sharing the personal income

taxes collected, one that would split them equally between local and central governments instead of the present 80:20 formula. A sustainable fiscal decentralization model would bring the deficit down by about 0.5–0.7 percent of GDP—€150–€210 million (see Chapter 10: “Fiscal Decentralization”).

***The remaining short-term savings (0.3–0.5 percent of GDP, €90–€150 million) would come from increased efficiency and rationalization of public administration.*** By that we mean improvement in the functioning of state agencies and extra-budgetary funds, savings in public procurement, and more effective tax collection. Although the public may believe otherwise, all these together actually offer very limited possibilities for saving, especially short-term. Most of the remaining necessary savings could be achieved by rationalization within agencies, directorates, and funds that are not under direct Treasury’s control. In 2012 there has actually been a significant *increase* in their expenditures—unlike the flows in the state budget—which must be stopped immediately. To establish an efficient permanent system of functioning for state agencies and non-budget funds, broader reform is necessary, including abolition of certain agencies and funds by, for instance, merging those that have similar functions, and bringing them into the budget (see Chapter 11: “Independent Revenues of Budget Users and Unbudgeted Funds”).[2]

***During the short-term fiscal consolidation, social protection of the most vulnerable groups must be a priority.*** Higher taxes and administratively controlled prices, along with the freezing of pensions and the salaries of those employed in the public sector, will result in a temporary drop in Serbian standards of living. However, the facts make it clear that the measures are necessary; if they are not done now, they will certainly be necessary after the otherwise inevitable crisis hits, and at that point they would naturally be even tougher and more painful. Therefore, the Government must recognize the obligation to protect the most vulnerable groups during the short-term fiscal consolidation. Means-tested programs of social assistance to households and minimal pensions should not be frozen. It will also be necessary, on both state and local levels, to intensify social protection programs and embark on a determined and nonselective battle against corruption (see Chapter 4: “Fiscal Consolidation and Social Policy”). The program of fiscal consolidation is formulated so that the heaviest burden is on those citizens whose earnings come from the public sector because currently their earnings are higher than average and there is less risk that they will lose their jobs. We stress again that the lower standard of living is only temporary. With consistent work on fiscal consolidation and other proposed reforms, it would be possible at the middle of the period covered here to compensate for their negative impacts so that by 2016 positive impact would supersede them.

***The Fiscal Council suggests short-term measures that are economically efficient and socially and politically acceptable, but there may be alternatives, depending on both the Government’s preference and macroeconomic developments.*** Out of many short-term fiscal consolidation models, we analyzed a variety of options for tax reform. One possible scenario was to raise the VAT rate in two phases instead of one—first to 20 percent in 2012, and then, as of January 1, 2013, to 22 percent—meanwhile relieving the fiscal burden on labor. This scenario would have advantages in that there would be a more moderate transfer to new tax

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[2] Impact assessment in the sectors analyzed indicates that it is possible to achieve the necessary saving in the short term, since the number of reforms evaluated (see Chapters 6–12, is slightly higher than the necessary savings. However, it is not realistic to expect that all the reforms will produce the theoretically best possible results by 2013, so achievement of the desired adjustment is uncertain.

rates but it would also have the disadvantages that in 2012 the fiscal deficit would be decreased only to 5.5 percent of GDP, and Serbia might miss the chance to let investors know that the new Government's priority is fiscal consolidation. Another option would be to keep the VAT rate increase to 20 percent and instead of the additional 2 percent increase to proceed with a nominal decrease of pensions and salaries of 5–6 percent. Generally speaking the two alternatives are practically equal from the point of view of fiscal consolidation, so the new Government could choose either. A third fiscal consolidation possibility would be to not freeze pensions and salaries but to raise the VAT rate as high as 26–27 percent. The Council considers this to be undesirable. There is a definite risk that by the end of the year the crisis in the Eurozone will escalate, which would decrease economic activity in Serbia, with consequent fiscal deterioration. In that case, along with all the stated short-term measures for fiscal consolidation, the planned decrease in contributions should be temporarily postponed.

***In medium term, the deficit should shrink from 3 percent of GDP in 2013 to a balanced budget in 2016 (a deficit of 0 percent).*** Short-term fiscal consolidation will put the brakes on the growth in public debt, but for permanent sustainability of Serbia's public finances, it is necessary to continue narrowing the deficit throughout the period till 2016. The entire mid-term deficit adjustment needed could be accomplished by spending less, rather than increasing tax rates. Also, not only does public spending have to be brought down, it is also necessary to change its unfavorable structure by significantly increasing the level of public investment. The 2012 level of 3.5–4 percent of GDP (as budgeted) is not enough to support economic growth. Therefore, within the general decrease of public expenditure of 3 percent of GDP in 2014–2016, it is absolutely necessary to bring down current public spending (for salaries, pensions, procurement of goods and services, and subsidies) by 4 percent of GDP in order to release 1 percent (€ 300–350 million) for capital investments.

***Current public spending of 4 percent of GDP can be brought down in 2014–2016 by formally indexing public pensions and salaries and implementing mid-term structural reforms.*** As of April 2014, after the 2012–2013 freeze pensions and salaries would again be indexed in accordance with the Budget Law. This would make it possible to bring down the share of salaries and pensions in GDP by about 2 percent by 2016. The remaining 2 percent of GDP needed in savings can be brought about by structural reforms rather than fiscal savings, which should also significantly improve the business environment, stimulate private sector development, and thus support economic growth. It is essential to emphasize two points here:

1. The first significant savings that will come out of the mid-term reforms can only be expected a year or two after they begin. It is, therefore, crucial to get started on the reforms in 2013 at the latest, which means they should be prepared during 2012.
2. Because this type of reform is not painless, in our analysis the Council decided to go into full detail about the measures we believe are necessary to ensure that Serbia's public finances get on a sustainable path.

***Pension reform and reform of salaries and the employment system would generate savings of about 0.6 percent of GDP.*** Contributions for pensions and salaries make up more than 50 percent of total public expenditure, so it is not possible to achieve the needed savings without rationalizing these items. The target of the pension reform would be to make the system not only more sustainable but also more just. Therefore, actuarial equity should be introduced into the pension system in terms of early retirement, a higher retirement age for women, and adapting age limits to increases in life expectancy (see Chapter 6: "Sustainability of the Serbian Pension System"). The savings these measures would produce by 2016 are not immediately high—about 0.2 percent of GDP if reforms begin in 2013— but their full effect and a permanent improvement of the pension system will be obvious in 10–15 years. The proposed reforms of public salaries and the employment system would mean introducing a unified system of salary levels for those employed in public service, fewer employees in local administration, fewer nonmedical staff in the health department, and more elementary teachers (see Chapter 7: “Reform of the Government Wage and Employment System"). This reform could produce savings of about 0.4 percent of GDP even by 2016.

***Reform of state-owned, socially-owned, and public enterprises would bring mid-term savings on subsidies of about 0.6 percent of GDP; it would also decrease the number of state guarantees of their borrowing, which, independent of the deficit, increase public debt.*** A particular social problem while reforms proceed could arise from the resolution of the status of about 640 companies being restructured within the jurisdiction of the Privatization Agency that still have a total of about 97,000 employees (see Chapter 8: “Reforms of State and Socially-owned Enterprises”). Every year these companies together lose about €400 million, and their arrears to the government and public companies have reached some €1.5 billion. Maintaining this system, more than 10 years after the transition began, is both costly and irrational. Among the measures the Council proposes are liberalizing activities in sectors where public and state-owned companies operate but which do not have the character of natural monopolies; raising prices for services provided by public state-owned and local companies to cost recovery levels; and improving the management of public companies and depoliticizing them to make them more cost-effective and more service-oriented. If state, socially-owned, and public enterprises were better operated, public spending on subsidies would fall (see Chapter 9: “Possible Savings on Subsidies”). Particularly worrisome is the fact that in the past three years there has been a surge in state guarantees of the borrowing of public companies (see Chapter 3: “State Guarantees”). Reforming public and state-owned enterprises will decrease the need for issuing guarantees, but the Fiscal Council is also proposing ceilings for them—legal limits on the annual growth of guarantees and on the purposes for which they can be issued. The number of guarantees has grown in recent years because they have been issued for economically unjustified purposes, such as current liquidity, refinancing of liabilities, and procurement of goods and services for daily operations.

***About 0.6 percent of GDP can be saved on procurement of goods and services.*** Goods and services are disproportionately procured outside the central state budget, through the Republic Health Insurance Fund, local governments, agencies, and extra-budgetary funds. Savings can be made both directly, by improving how public procurement is managed, and indirectly, by improving the efficiency of local governments and the local business environment (see Chapter 19) and the work of state agencies and extra-budgetary funds (see Chapter 11). With the help of such reforms, total mid-term savings on procurement of goods and services by 2016 are estimated at 0.6 percent of GDP.

***The remaining 0.2 percent of GDP necessary in mid-term savings can be obtained by lowering interest payments.*** Fiscal consolidation and structural reforms will help bring spending on interest down through two channels. The first, which is more significant for adjustment, is decreasing the share of public debt in GDP. Fiscal Council projections show that by implementing the proposed short-term and mid-term measures, it would be possible to decrease the share of public debt by about 7 percent—from 55.8 of GDP to 48.6 percent (not including debt related to restitution).[3] Lessening the share in GDP of public debt directly decreases annual interest expense. The second channel for lessening interest payments is by getting lower interest rates on state borrowing: when public debt drops, the confidence of

[3] Due to a relatively low interest rate for state obligations related to restitution, expenditures for interest payments will not change significantly.

investors in the state's solvency rises, which lowers the risk and, therefore, the interest rate on borrowing.

***Fiscal consolidation and structural reforms will also lay the foundation for high and sustainable economic growth.*** A major drop in the deficit in 2012 and 2013 would provide macroeconomic stability and avoid both a possible depreciation of the dinar and an escalation of inflation—the principal reason the Fiscal Council prepared this study in the first place. However, lowering the deficit also has a positive influence on economic growth in both the short- and the mid-term:

1. Fiscal consolidation will provide more favorable financing for the economy because it decreases the country-related risk premium and the government borrows less on the domestic financial market.
2. Structural changes in public revenues and expenditures (increased investment) will undoubtedly help to rebalance the Serbian economy toward exports and increase competitiveness through the effects of fiscal devaluation.
3. Mid-term structural reforms will contribute to growth by improving the business environment, stimulating private sector development, and making the business environment more predictable. If developments in the Eurozone worsen and there is an extended recession, these proposals would guarantee sustained macroeconomic stability in Serbia.

The Fiscal Council is convinced that fiscal consolidation is crucial, but alone it is not enough to ensure the long-term sustainability of economic growth and increased employment. Reforms supportive of both fiscal consolidation and economic growth are, among others, reform of the tax system, enforcing financial discipline, addressing the issue of the informal economy, simplifying administrative procedures, attacking corruption, developing and modernizing infrastructure, improving the quality of public services (judicial, educational, administrative, etc.), and reforming state-owned enterprises. All sectoral reforms (in education, health, defense, agriculture, culture, science, etc.) must be integrated into the general, balanced policy framework that is underpinned by fiscal consolidation, which means keeping public spending at about 40 percent of GDP. The consequence is that the GDP share of most of these sectors in the next four years will be decreased (though in a few cases they will remain unchanged)—which means that sectors can only realistically count on receiving higher amounts if there is growth in real GDP. However, there are clearly many other reforms not directly linked with fiscal consolidation that are necessary to create a favorable environment for economic growth. Among them are reform of the labor market, improvement of competition policy, and more competitive policies for areas like agriculture, the non-banking financial sector, and research and development.

# PART ONE:

# FISCAL CONSOLIDATION, STABILIZATION AND DEVELOPMENT

## 1. NECESSARY FISCAL ADJUSTMENT IN THE SHORT AND MEDIUM TERM

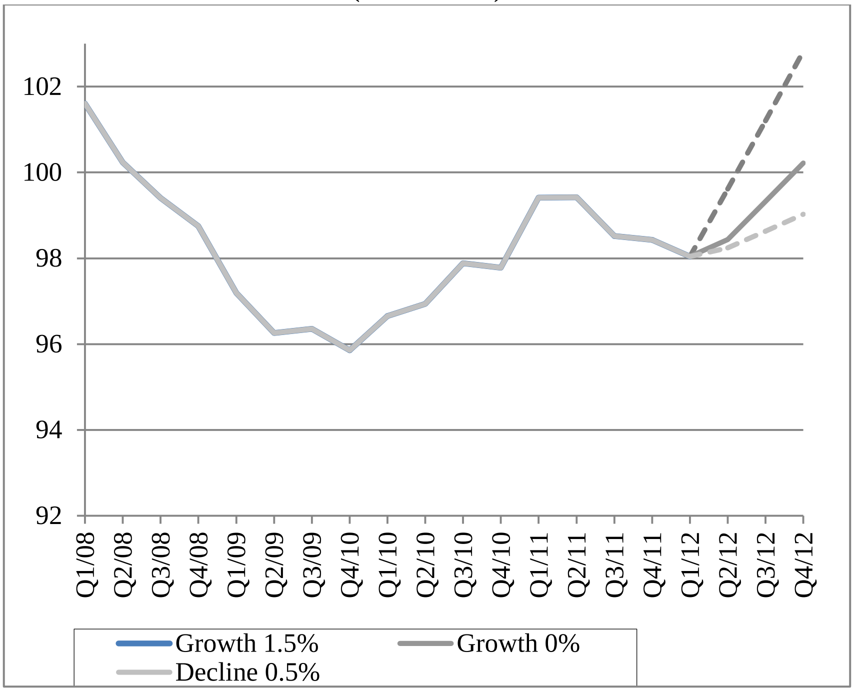
In this chapter we analyze the necessary fiscal adjustment in the short and medium term, considering the current economic and fiscal trends. Here we also give a brief overview of all basic measures that we propose, as well as their expected impact on fiscal consolidation – cutting and curbing deficit, reducing public debt.

### 1.1. Economic and Fiscal Trends in 2012

#### *1.1.1. Economic Activity in 2012*

***Fiscal Council analysis indicates that in 2012 the GDP growth will be around 0 percent, but there are also significant risks of negative economic growth.*** A preliminary estimate for Q1 2012 made by the Statistical Office of the Republic of Serbia indicates a year-on-year GDP decline of 1.3 percent. In principle, this estimate corresponds to the Fiscal Council expectations announced in December[4], when we estimated that 2012 economic growth will be 0 percent – and that it will be the result of a somewhat weak economic activity in the first half of the year and the export-led recovery to be achieved in the second half. However, if the economic crisis in Eurozone persists or becomes wider, it is almost certain that Serbian GDP will decline in 2012 due to the close interconnection between the two economies. This is why we believe there is considerable risk that Serbia will face downturn of output instead of the expected stagnation in 2012.

**Graph 1.1 Deseasoned GDP Growth, Projections after Q1 2012**
(2008 = 100)




Source: Fiscal Council, based on the Statistical Office data

[4] "Evaluation of the Fiscal Strategy Report and the Draft Budget Law of the Republic of Serbia for 2012".

***Government fiscal plans for 2012 anticipate GDP growth by 1.5 percent (that will not be achieved) which is why the tax revenues will be lower than planned by approximately RSD 20 billion.*** Following the Q1 results, it is already almost certain that the 2012 economic growth will not reach 1.5 percent. In Graph 1.1, presenting the deseasoned GDP we showed how the economic activity curve should look like over the rest of the year in order for the economic growth to achieve the anticipated 1.5 percent (upper dotted line in the Graph 1.1). The graph itself is quite self-explanatory, and it can be easily analytically demonstrated that such a fast recovery of the Serbian economic activity by the end of 2012 is impossible. Two lower lines in the graph correspond to the total growth of the economic activity in 2012 – from 0 percent to -0.5 percent and they are actually projected in such a way to make the production recovery during the rest of the year similar to that recorded after the first wave of the crisis (2010). We find that this recovery curve is probable, which is why our projection of 2012 economic growth is around 0 percent. Given that the public revenues for 2012 are planned on the basis of the overestimated 1.5 percent GDP growth, we assess that due to the lower economic activity growth the resulting public revenues in 2012 will be lower by approximately RSD 20 billion (0.6 percent of GDP) than planned.

***In Q1 2012 a relatively high growth of the domestic consumption prevented the y-o-y decline of economic activity to be even higher than 1.3 percent, but such trends are not sustainable – even in the short term.*** Considering the individual GDP components (private consumption, government spending, investments and net exports)[5], the y-o-y GDP drop in Q1 of 1.3 percent is actually a sum of two divergent trends – on one hand, there was a large growth of government spending and somewhat lower, but positive, growth of private consumption, and on the other hand there was a sharp decline of investments and net exports.[6] Government spending in Q1 reached a significant y-o-y real growth of as much as 7.5 percent, positively contributing to the y-o-y GDP growth with 1.2 percentage points. The private consumption had a much lower y-o-y growth than the public consumption, but due to the larger GDP share, its contribution to GDP growth was bigger – 1.4 percentage points. Investments negatively contributed to the economic growth in Q1 with 1 percentage point, while net exports contributed to the GDP decline with approximately 3 percentage points. All components together indicate the y-o-y production drop in Q1 of about 1.4 percent, which is in line with the preliminary estimate of 1.3 percent made by the Statistical Office. The described trends – consumption growth and decline of net exports and investments – result in a dangerous increase of macroeconomic imbalances and, as such, these trends are unsustainable. Current account deficit rose sharply in Q1[7], which was also fuelled by the unsustainable increase of the fiscal deficit reaching almost RSD 55 billion from the beginning of the year until the end of March.

***The year-on-year growth of public and private consumption recorded in Q1 is temporary.*** Government spending (G) is approximated by public expenditures for wages and procurement of goods and services or the value of services provided to the citizens by the government (defense, national security, other administrative services, public education and

[5] In economic theory, these components are usually marked with *C, G, I and X-M.*

[6] Unfortunately, the Statistical Office does not monitor the GDP utilization on a quarterly basis which is why we analysed the trends of individual components on the basis of indirect indicators (trends in wage bill, pensions, construction activity, capital goods imports, retail and wholesail loans) which describe the trends in GDP components.

[7] Current account deficit in Q1 2012 stood at EUR 1.16 bln compared to 760 million reached in the same period last year resulting in the dinar weakening.

public healthcare) and it reaches 17-19 percent of GDP. Compared to the last year and in real terms, these expenditures rose (by approximately 7.5 percent).

Expenditures for wages showed a significant y-o-y real growth in Q1, which was, *inter alia*, a consequence of the strong curbing of inflation following April 2011.[8] Procurement of goods and services saw a large real growth of 10 percent in Q1. In addition to the undeniable influence of the extraordinary weather conditions in February that led to the greater expenditures of this kind, this was probably once again the case of stronger pre-elections spending. Government spending will have to significantly slow down until the end of the year as the further increase of deficit and public debt, which would serve as its source of funding, is economically unsustainable. We approximate the private consumption by analyzing the trends of its major funding sources – wage bill[9], pensions, retail lending and remittances. The available data indicate that the y-o-y real growth of the private consumption in Q1 is somewhere between 2.5 percent and 3 percent, but in this case we expect further curbing by the end of the year. Due to the slowdown of the total economic activity, the unfavorable market trends will probably worsen (wage bill trends depend on the wages and employment), and we have also detected a significant decline in retail lending, which will probably continue in the future.

***Investments showed a y-o-y drop in Q1 and we do not expect any major changes until the end of the year.*** Lower investment activity in Q1 is evident from the weaker imports and domestic production of capital goods, as well as the lower production of construction material. Some other indicators mitigated these unfavorable trends to some extent – such as the mild increase of wholesale lending and a sizeable rise of public investments. Considering all the above, we estimate that in Q1 investments showed the real y-o-y decline of around 5 percent. A somewhat lower level of investments in 2012 compared to 2011 was indeed expected since the big projects launched in 2011 are either completed or in their final phase (FIAT, NIS). Without new, similar projects the same high level of investment activity recorded in 2011 cannot be expected. Therefore, we do not anticipate any significant changes in this respect by the end of the year relative to Q1. However, one should not neglect the risks of further aggravation of investment activity until the end of the year, even though we do not expect that to happen yet. It is likely that the growth of public investments will slow down compared to the growth made in Q1, but their share in the total investments is not big, and they will not significantly affect the total trends. Much more adverse effect would come from the sudden drop of lending activities, which can result from various events affecting the financial sector (the rise of sovereign credit risk, growing number of non-performing loans, withdrawal of capital by EU-based banks, etc.)

***Sharp reduction in net exports in Q1 is most probably of temporary nature – by the end of the year we expect the acceleration of exports and slowdown of imports.*** In Q1 the exports of goods and services showed a y-o-y decline of 2.2 percent, while the imports of goods and services showed the y-o-y growth of 1.4 percent. However, a detailed analysis reveals that the total export was significantly affected by the decline in the exports of base metals probably due to the problems faced by Smederevo Steel Mill, but also owing to the extraordinary weather conditions in February, when the exports of goods recorded the y-o-y

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[8] Due to the almost zero-level inflation from April 2011 until Q1 2012, the nominal increase of wages resulting from the regular semi-annual indexation performed in April 2011 (paid in May) practically became the real y-o-y growth in Q1. This effect will disappear starting from May 2012. We have described this eefect in more detail in several previous reports of the Fiscal Council.

[9] According to the social accounting method, pensions, social benefits and other transfers from the goevernment to the citizens are deemed part of the private consumption.

fall of 20 percent. The Q1 increase of imports was also influenced by the significant rise in the imports of energy commodities (18.5 percent) which was also partly caused by the temporary extraordinary weather conditions (unusually severe winter).

Over the rest of the year we anticipate the growth in net exports due to the following: 1) termination of effects coming from adverse temporary factors in Q1; 2) launching of production in the FIAT Automobiles Serbia; and 3) dinar depreciation in the end of 2011 and during the first half of 2012 causing the increase of price competitiveness of the domestic economy. Despite all the above, it is still uncertain whether the increased net imports over the rest of the year will be enough to turn around the GDP trend (Graph 1.1). We wish to stress that this means that the growth of net exports should first compensate for the inevitable slowdown of government and private spending by the end of the year, but the anticipated growth should also be sufficient to bring about the shift in the total GDP trend. We believe that this is plausible, despite many risks, and as a consequence the economic growth in 2012 would still reach 0 percent.

***There are serious risks that the economic activity will be lower than the estimated 0 percent.*** As seen from the previous analysis of the possible trends of components, there are major risks of GDP shrinking in 2012 instead of stagnating. We have stressed two main reasons why this year's GDP trends can be worse than predicted by the Fiscal Council. The first reason is of a more technical nature and pertains to the unreliable preliminary assessments of the economic activity trends (but also generally unreliable estimates of GDP) made by the official statistics. If the estimated drop in Q1 of 1.3 percent proves to be too optimistic, this will also have a domino effect on the economic performance by the end of the year. For now we believe that the preliminary estimate of the Statistical Office is correct, given that similar results have also been obtained from the analysis of the GDP components. However, one must always bear in mind that the GDP analysis, for which there are no official data on the quarterly level, is not sufficiently reliable. We wish to stress that the Statistical Office preliminary estimate for Q4 forecasted the growth of 0.8 percent, but soon after it was adjusted to 0.4 percent. The second risk is much more serious and relates to the possibility of Eurozone not achieving the expected recovery in the second half of 2012. If this should happen, the ramifications will be felt in Serbia through the diminishing demand for exports (EU is by far the most important exports market), lower FDIs, but possibly also through an outflow of foreign capital from the domestic financial system. This is why the most important preconditions for the anticipated recovery of production in the second half of the year are the favorable developments in the EU market.

***Serbian medium-term economic growth will primarily depend on the structural reforms and the economic policy, as well as the economic developments in Europe. Within the economic policy the key role will be played by the fiscal policy.*** Fiscal Council analysis shows three possible scenarios when it comes to the economic activity trends, depending on the fiscal policy opted for by the new Government. The first option is the scenario that would happen if no major measures are undertaken for the reduction of fiscal deficit in 2012 and 2013. Strong public debt growth over the past several years significantly increased the possibility of the public debt crisis. Under this assumption, the similar trend will continue resulting in the outbreak of the crisis and the new recession, which would probably be even worse than the previous one – the economic activity would undoubtedly shrink by more than 5 percent. The second possibility implies that the fiscal policy is pursued in the form of non-systemic, *ad hoc* measures that would briefly ensure macroeconomic stability, but failing to implement radical reforms that would lead to the long-term stability. Under such circumstances, the macroeconomic instability and a far-reaching recession might be avoided, but the economic growth would remain low in the next four years and probably could not exceed 3 percent a year. The third option, which we propose in this study, is to immediately implement the short-term fiscal consolidation measures (tax increase, pension and wage freeze) and initiate the medium-term reforms that would in the next four years lead to the gradual reduction and different structure of public expenditures, and the overall improvement of the business environment. In this case, the short-term fiscal consolidation would have a negative effect on the GDP growth in 2012 (we estimate that the GDP growth might reach between 2 percent and 2.5 percent instead of the anticipated 3 percent), but this would create the foundations for the rapid GDP growth starting from 2014.[10] Consequently, before 2016 the GDP growth rates would reach, and probably even exceed 5 percent, entirely surpassing all the negative short-term effects of the fiscal consolidation by the end of the Government term, which would not be the case if the reforms are only "partially" implemented.

*Change in Nominal GDP*

In mid-May, the Statistical Office published the official nominal GDP data in 2010 which is by over 3 percent lower than the initial estimate. Based on the new nominal GDP data, the 2011 fiscal deficit equals 5 percent of GDP instead of 4.7 percent of GDP, and the public debt level as of end 2011 stands at 48.9 percent instead of 46.6 percent of GDP (according to the methodology set out in the Budget System Law). We have incorporated the said changes in all the existing data measured relative to GDP, as well as the related projections.

Pursuing of economic policy in Serbia is hindered by the fact that there are no timely and correct statistical data regarding GDP. Namely, the final revision and the publication of the official nominal GDP data come over one year after the end of the current year. In the previous few years it has almost become a regular practice that the official nominal GDP data is significantly adjusted downward relative to all the previous estimates. The problem is that all economic decisions, often those with extremely important implications, can be made only on the basis of the present estimates, which in the last few years proved extremely unreliable.

The second problem is that even after the last corrections we are not completely certain that the last published, official GDP data for 2010 is correct, as it is not in line with some other, more reliable and directly measured macroeconomic aggregates. Namely, out of all statistical data that we have access to, the most reliable are the foreign trade and fiscal data. These data are recorded on a regular basis and measured directly, which is why the possibility of error is very small. According to the foreign trade data, in 2010 the net exports grew markedly and were the only GDP component with the positive growth that year. The faster growth of net exports compared to the other GDP component should lead to the lower share of tax revenues in GDP, since the exports tax burden is lower than the burden for the domestic consumption. However, with the new, reduced GDP value for 2010 the share of tax revenues in GDP is growing[11] instead of falling as expected. This is why we believe it is possible that not even the new official estimate of GDP is entirely reliable. Similarly, the

[10] There are several chanels through which the fiscal consolidation cruically affects the rapid economic growth in the medium term. The sovereign credit risk would diminish, and consequently the interest rates would drop; increased public investments and the lower consumption would increase the multiplicative effect of government spending on the economic growth. Empirical research have shown that the lower share of public consumption in countries like Serbia has a positive effect on the conomic growth etc. See chapter 5 – *Fiscal Consolidation and Economic Growth*.

[11] An even more detailed analysis only focused on the share of VAT revenues in GDP and indicated that this share also rises.

share of VAT revenues in the official Serbian GDP is now among the highest in Europe, despite the fact that the VAT rate in Serbia is one of the lowest in Europe. This is hardly correct as the absorption gap has been significantly reduced in the previous three years. It is even less likely that the VAT collection is Serbia is among the most successful in Europe.

There will probably be another adjustment of GDP data, this time upward – due to the new estimation and inclusion of the economy that was not included in GDP. Similar adjustments have already been carried out in some countries of the region (Croatia and Bulgaria). The comparative analysis, as well as the information contained in the previous, similar study performed by the Statistical Office in 2007 states that the official GDP data in Serbia underestimates its actual value by approximately 10 percent due to the non economy. We expect that GDP will increase by approximately this much when the new research currently performed by the Statistical Office is completed (most probably in 2013). The increase of GDP by 10 percent owing to the inclusion of the omitted economy will result in the lower ratio of public debt, tax revenues, public consumption, etc- to- GDP by around 10 percent.

*1.1.2. Assessment of Fiscal Trends in 2012*

***During the first three months of 2012 the consolidated deficit stood at RSD 54.1 billion, which is far more than the planned RSD 26 billion.*** Q1 data undoubtedly indicate that the fiscal deficit foreseen for 2012 will be significantly exceeded. Namely, the plan, which is agreed with the IMF, states that the Q1 deficit will be RSD 26 billion, which would correspond to the total annual deficit of RSD 152 billion. However, the consolidated Q1 deficit is by almost RSD 30 billion higher, which is too high difference to be compensated during the rest of the year. Therefore, it is already certain that the planned annual 2012 deficit in the amount of RSD 152 billion will be significantly exceeded.

***The sizeable deficit growth recorded in the first three months of 2012 is continuing in April.*** The last available data for April indicate that the high deficit in Q1 2012 was not only the consequence of the negative one-off impacts on the public finance (extraordinary weather conditions in February, earlier disbursement of subsidies, etc.). April data show further increase of the general government deficit beyond the planned level, and, as it seems, the deficit will be near RSD 80 billion for the first four months of 2012 – which means that already in the first four months of this year over half of the total planned deficit is “spent.”

***It is difficult to make the estimate of fiscal trends until the end of the year.*** The data for the first three months of 2012 are not entirely representative due to the unusually large number of temporary factors. In February, the extreme weather conditions led to the lower level of tax revenues, in January there was a temporary decline in the VAT revenues (the December VAT returns were postponed with the aim to reduce the 2011 deficit, which caused the greater return and lower VAT net-revenues in January). In March, on the other hand, we observed a one-off increase of public revenues, which is probably the consequence of somewhat larger usage of funds from the dividends of public enterprises. When it comes to the budget expenditures, there was a sizeable increase of the expenditures incurred by the budget beneficiaries that generate own-source revenues, and we are not sure whether these expenditures will continue to grow until the end of the year (from these funds, a portion of agricultural subsidies was disbursed). On top of that, there was an evident pre-elections increase of public expenditures – which has become a usual undesirable practice in the Serbian public finance management.

***The planned deficit will most likely be exceeded by approximately RSD 50 to 60 billion, i.e. the 2012 deficit will probably be around RSD 205 billion.*** The data for Q1 2012, when the plan was already exceeded by around RSD 30 billion, imply that there is a great probability of fiscal deficit reaching much larger level by the end of the year than planned in the budget, but it is also possible that the deficit will be somewhat larger than the Fiscal Council estimate made in December.[12] Namely, the Fiscal Council preliminary estimated in December that the 2012 deficit will be higher by around RSD 30 billion than the planned RSD 152 billion, as we expected that this will be the size of the public revenues underperformance. We identified two reasons why 2012 should see weaker inflow of public revenues than planned: 1) the budget is planned on the basis of the 2012 economic growth of 1.5 percent of GDP, while our December estimate (proved by the first quarter data) forecasted the economic growth of 0 percent; 2) too optimistic planning of budget revenues, even with the real GDP growth of 1.5 percent. A new aspect with respect to our December estimate is the high probability that public expenditures will also be higher than planned by around RSD 25 billion - primarily due to larger allocations for wages than planned (by around RSD 15 billion). Considering all the above,[13] we expect that the consolidated general government deficit in 2012 will be larger by around RSD 55 billion relative to plans, and that it will reach approximately RSD 205 billion (6.2 percent of GDP).[14]

***There are strong further risks that the fiscal deficit will exceed the estimated level.*** The latest data on the economic growth for the last quarter of 2011 and the first indicators for Q1 2012 (the preliminary estimate of GDP, drop of industrial production, exports and retail trade) indicate the possibility of having a negative economic growth in 2012. Fiscal Council stands by its December estimate – that the GDP growth in 2012 will be around 0 percent, but concurrently noting that this would happen if the second half of 2012 sees a relatively strong recovery of production. If there is no such recovery, GDP will shrink leading to the reduction of tax revenues. In addition, depending on how the upcoming government financial intervention in Agrobanka and Development Bank of Vojvodina is classified, this might also increase the public expenditures in 2012.

***At the end of 2011, public debt exceeded the statutory limit of 45 percent of GDP and is continuing to grow in 2012.*** When measured using the definition set in the Budget System Law, the Serbian public debt stood at 48.9 percent of GDP at the end of 2011[15]. By the end of 2012, the public debt will most likely be around 55 percent of GDP, which for the countries similar to Serbia has proven to be the level allowing for the possible public debt crisis (see chapter 2 – *Public Debt Sustainability*). The public debt level, which is significantly above the legal limit and is very dangerous from the point of view of possible public debt crisis, will have to be a key parameter to be considered when designing the fiscal policy in Serbia.

***Government deposits have diminished, which is why new borrowing on the financial market is necessary in order to cover public expenditures.*** By the end of April 2012, the

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[12] See "Evaluation of the Fiscal Strategy Report and the Draft Budget Law of the Republic of Serbia for 2012."

[13] For the sake of simplicity we did not explain that the reduction of the estimated nominal GDP by the Statistical Office also contributed to the increased share of fiscal deficit in GDP (around 0.3 pp). More precisely, the deficit of 6.2 percent of GDP can be presented as the sum of the planned deficit of 4.25 percent, underperformance of revenues by 1 percent of GDP, increase of tax expenditures of 0.7 percent of GDP and the additional 0.3 percent due to the downward GDP adjustement.

[14] In the second half of the year we expect the recovery of the economic activity and the end of the effects coming from the one-off increase of expenditures (pre-elections spending, earlier disbursement of subisides, one-off payments of bonuses for employees, election costs, etc.), which is why the discrepancy from the planned quarterly fiscal deficits caused by the lower revenues and higher expenditures should be smaller than in the first half of the year.

[15] With the new GDP estimate of the Statistical Office.

largest part of deposits generated through the September 2011 issuance of Eurobonds has been spent. The beginning of June should see the payment of frozen foreign currency savings, which would further reduce the amount of the government deposits to the level which requires new significant borrowing. As a result, the new government borrowing on the financial market that will result in the increase of public debt is now indeed necessary. At the same time, this will be a good test of the investors' perception and a way to see if they deem Serbian fiscal policy sustainable.

### 1.2. Projections of Fiscal Trends from 2012 until 2016

***Immediately after being established, the new Government will have to face unfavorable public finance trends.*** The new Government will have three possible responses to the current fiscal trends. The first option is not to do anything and let the trends from the first half of 2012 continue. The second response implies a similar manner of implementing fiscal measures to that pursued during the previous four years (alleged conformity to fiscal rules regarding deficit, indexation of pensions and wages in the public sector according to fiscal rules, *ad hoc* deficit reducing measures). The third option is to carry out the fiscal consolidation measures cutting the fiscal deficit by around EUR 1 billion in the short term (3 percent of GDP) over 2012 and 2013, and then reaching the balanced budget in 2016 through the mid-term reforms of public sector. The first option would most likely result with a crisis by the end of the year, which is why we will not consider it in detail. A thorough analysis of the other two scenarios shows that the public debt crisis will not be easily avoided if the public finances are managed as it was done during the previous four years. In other words, it is necessary to implement a carefully designed and comprehensive fiscal consolidation.

***We performed a detailed analysis of the scenario where the new Government inherits the current fiscal deficit in 2012 (around 6.2 percent of GDP) and continues to apply the fiscal rules regarding deficit.*** Wages and pensions would still be indexed according to special fiscal rules, and all additional adjustments would be made on the expenditures side of the budget – it is assumed that there will be no tax increase. An illustration of the major macroeconomic aggregates and public expenditures is shown in Table 1.1.

**Table 1.1 Scenario of Keeping the Fiscal Policy Model Pursued during 2009-2011 (percent of GDP)**

| Year | Deficit | Public Revenues | Public Expenditures | Public Debt | GDP Growth (percent) |
|---|---|---|---|---|---|
| **2012** | 6.2 | 41.8 | 48.0 | 54.9 | 0 |
| **2013** | 5.0 | 41.2 | 46.2 | 59.3 | 3 |
| **2014** | 4.2 | 41.1 | 45.3 | 61.7 | 3 |
| **2015** | 3.7 | 41.0 | 44.7 | 64.4 | 3 |
| **2016** | 3.3 | 40.9 | 44.2 | 66.7 | 3 |

Source: Fiscal Council

***Table 1.1 shows how unsustainable the considered scenario is and what are the implications of continuing the similar fiscal policy that was pursued over the previous years.*** As early as in 2013, public revenues will show a sharp drop compared to 2012 (by approximately 0.6 percent of GDP) since the plan for 2012 is to generate one-off revenues from the companies under insolvency proceedings that will not be available in 2013. According to the fiscal rules on deficit, in 2013 the deficit would have to be reduced by 1.2

percent of GDP. Together with the expected decline of tax revenues, legally prescribed indexation of the biggest items in budget expenditures (pension, wages and interest) and the unchanged share of investments in the government spending – the only solution is to save about 1.4 percent of GDP or EUR 400 million on the other expenditure items (goods and services, subsidies), which we believe is not feasible over the course of one year. Consequently, without increasing one of the most important tax rates and/or freezing the largest items of public expenditures (wages and pensions) it will not be possible to achieve a long-term, sustainable fiscal policy.

***However, the biggest problem of this scenario is the unsustainable growth of public debt.*** We projected the public debt trends depending on the level of fiscal deficit and with the assumption that the level of issued government guarantees (which according to the Public Debt Law and Budget System Law form part of the public debt stock) will decline by one third compared to the period 2009-2012. Even under these more conservative assumptions, the public debt will continue to grow until 2016 when it will exceed 65 percent of GDP (Table 1.1). When we add the government liabilities related to restitution, which will come into force in 2015, in 2016 public debt would go beyond 70 percent of GDP.

***This scenario shows that the public debt crisis is extremely likely.*** A significant growth of public debt resulting from the previous analysis not only goes far beyond the legally stipulated limit of 45 percent of GDP, but almost certainly reaches the economic level when the public debt crisis arises in developing countries (Table 1.1). Therefore, without a strong fiscal consolidation which, *inter alia*, includes tax increase, as early as in the first year of its term, the future Government will not be able to avoid the crisis and macroeconomic instability.

***Considering all the above, we come to the following conclusion: the approach which entails that only the fiscal rule on the maximum allowed deficit is complied with in 2013 and onwards, while the fiscal rule on public debt is ignored will not only make it impossible for the Government to avoid the public debt crisis, but this adjustment will not even be possible without increasing major taxes and containing biggest tax expenditures (pensions and wages).***

### 1.3. Size of the Necessary Fiscal Adjustment (Consolidation) up to 2016

***The public debt crisis can only be avoided with strict measures of short-term fiscal consolidation to be implemented in 2012 and 2013, with future continuation of medium term adjustments over the period 2014 – 2016.*** Graph 1.2 shows public debt curves for the above described scenario (Table 1.1) and for the fiscal consolidation that we propose here. The objective of the fiscal consolidation is to curb the public debt in 2013 and bring it close to the statutory limit of 45 percent of GDP in 2016.[16] This can only be achieved with the sharp cuts within public finances during the first year of the Government term, followed by the continued reduction of fiscal deficit until the balanced budget is reached in 2016. We wish to stress that the key factor for the shift in the public debt trend is the immediate and significant

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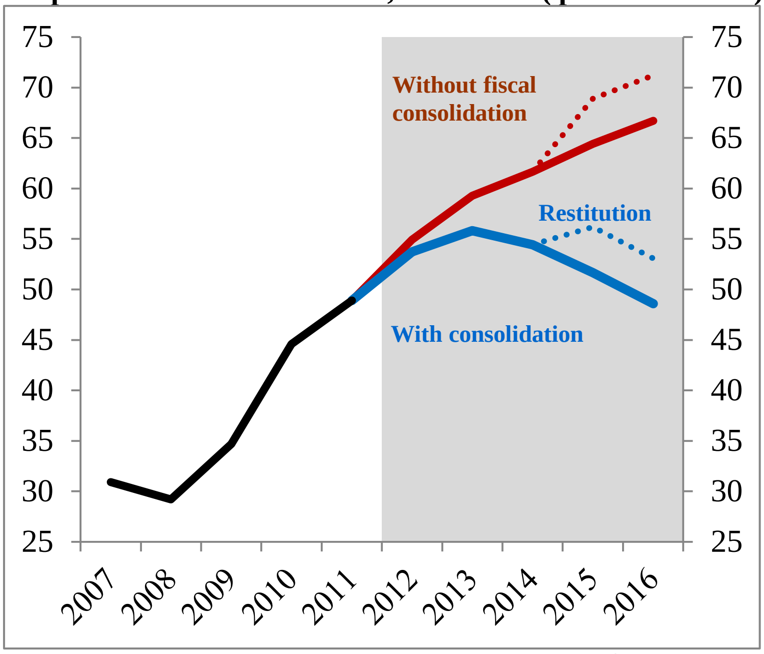
[16] The graph shows that the maximum effect which the fiscal consolidation would have on the public debt (restitution excluded) is the reduction to around 48.5 percent of GDP in 2016. However, with the expected increase of GDP by approximately 10 percent, which will most probably happen until 2016, the fiscal consolidation would bring the public debt in 2016 below the legally set limit of 45 percent of GDP. We emphasize that the most important economic factor is to turn around the share of public debt in GDP, as it could lead to the outbreak of the public debt crisis should there be no fiscal consolidation (upper line in Graph 1.2).

reduction of fiscal deficit (in 2012 and 2013), since any other trajectory for reducing deficit (even if it also resulted in the balanced budget in 2016) would not have the necessary impact on the evolution of the public debt.

**Graph 1.2 Serbian Public Debt, 2007–2016 ( percent of GDP)**

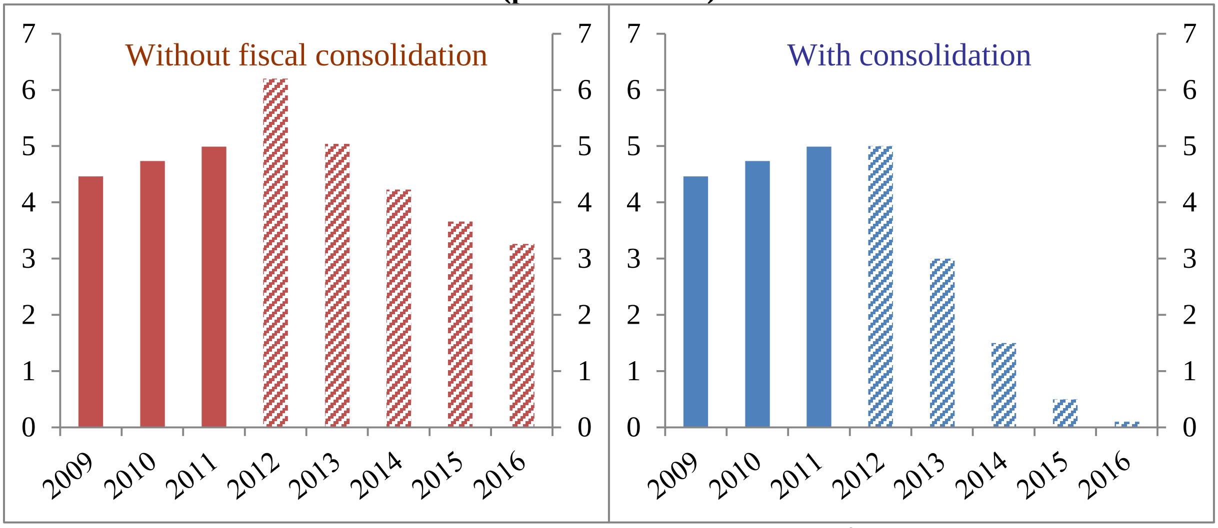



Source: Fiscal Council (up to 2012 based on the Ministry of Finance data)

***Two main components defining the evolution of the public debt are the level of fiscal deficit and the issuance of government guarantees for the borrowing of third parties.*** The projected fiscal deficits that would lead to the sustainable public debt trajectory are shown in Graph 1.3. We have made a comparative illustration of the deficit movement should the new Government fail to implement the fiscal consolidation during the first year of its term, but only followed the deficit rules (the scenario considered under item 1.2 above).

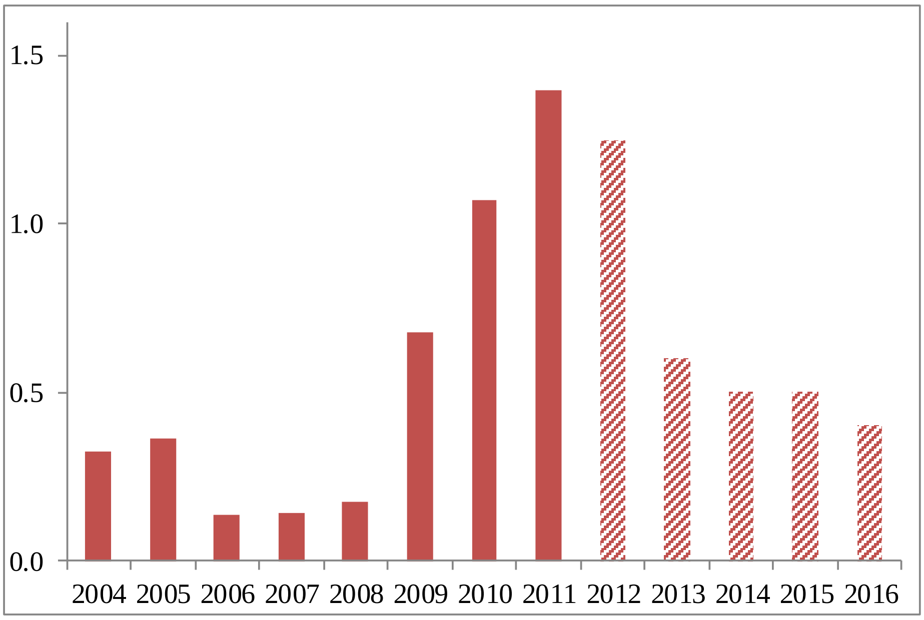
***The sustainability of public finances requires two types of measures.*** Graph 1.3 shows that it is necessary to significantly reduce the deficit in 2012 and 2013, which can only be accomplished with short-term measures that would produce fiscal effects immediately after their adoption. However, we can see from the graph that this alone will not be enough, but it is also important to continuously cut the deficit until 2016, even after the effects of the short-term fiscal consolidation are exhausted. Therefore, it is necessary to carefully prepare the second group of measures that would include a larger number of reforms. These reforms would have to come into effect as early as in 2013, since their first fiscal effects leading to the lower deficit could not be felt before 2014. This is why we divided our proposal in the following manner: 1) proposed measures of short-term fiscal consolidation and 2) medium-term savings measures. On top of this, strict limitation on the issuance of government guarantees is vital.

**Graph 1.3 Serbian Fiscal Deficits with and without Fiscal Consolidation, 2009–2016 (percent of GDP)**




Source: Fiscal Council (up to 2012 based on the Ministry of Finance data)

**Graph 1.4 Annual Growth Rate of Guarantees* over 2004–2012 with Projections of Their Limitation over 2012–2016 (percent of GDP)**




*Guarantees for the borrowing of PE "Roads of Serbia" and local governments are not included.
Source: Fiscal Council (up to 2012 based on the Ministry of Finance data)

***The growth rate of issued guarantees should be brought back to the level maintained during 2006-2008.*** Since 2009, there is a strong growth of the issued government guarantees (Graph 1.4) which is why public debt rose markedly. The average growth rate of issued guarantees in the period 2006-2008 was 0.3 percent of GDP, while from 2009 to 2012 this rate rose to over 1 percent of GDP. In order to put the public debt under control (lower line in Graph 1.2) there must be rigorous limitation on the issuance of government guarantees in the following period.[17] In practice, this would imply a significant reduction of the state aid to the public enterprises (Srbijagas, JAT, Serbian Railways, EPS).[18] The authorities should also reduce the public debt stemming from direct borrowing for the activities that are not aimed at financing deficit (borrowing "below-the-line"). The consequence of this would probably be giving up on some of the government's planned activities (capital increase, etc.). We believe that the economically desirable implication of the necessary limitations on the issuance of government guarantees and below-the-line borrowing will be a much needed re-examination of the government's role and ownership in certain economic operators. We wish to underline that due to its sizeable share of public sector in GDP (40 percent, according to the EBRD) Serbia significantly deviates from almost all transition economies in Europe.

### 1.4. Proposed Measures for the Short-Term Fiscal Consolidation

***Fiscal consolidation is supposed to reduce the fiscal deficit by approximately 1.2 percent of GDP in 2012 and by additional 2 percent of GDP in 2013 (Table 1.3).*** Such a large fiscal adjustment requires robust measures both regarding public revenues and public expenditures. The set of measures proposed by the Fiscal Council under the short-term fiscal adjustment is the combination of increasing certain tax revenues (VAT and a portion of excises) and freezing of pensions and wages in the public sector. Even though this combination of measures is economically most desirable, it should be mentioned that the authorities might opt for the nominal reduction of pensions and wages, instead of increasing taxes, or for the significant increase of taxes with the continued growth of pensions and wages, which we believe is the worst possible option. We have thoroughly analyzed the option that we find is the optimal one – the combination of increasing certain tax revenues and freezing pensions and wages in the public sector – while the said alternative set of measures are presented in the box below.

***For the purpose of fiscal consolidation, during the first year of its term the new Government must pursue a tax policy that brings positive results.*** From Graph 1.3 we have concluded that the macroeconomic stability requires rapid reduction of deficit in 2012 and 2013. This actually means urgent increase of some of the most important tax rates, since otherwise the objectives of the necessary short-term fiscal consolidation will not be achieved. Fiscal Council believes that the raising of taxes should be part of a more comprehensive tax reform which should address several fiscal policy issues: a) it should support the necessary short-term fiscal adjustment over 2012 and 2013; 2) it should stop the fall of the public revenues share in GDP until 2016; but also 3) it should enable the improvement of the business environment through the change in the economic structure and support the new export-based growth model through fiscal devaluation.

***However, tax reform cannot be the main mechanism for adjusting public finances.*** Comparative analyses show that in the countries similar to Serbia it is not desirable for the public revenues to exceed 40 percent of GDP, which is why it is necessary to place the biggest portion of the adjustment burden on the expenditures side. Therefore, the effects of the tax reform should not result in the tax revenue increase of more than 1 percent of GDP, and the rest of the adjustment efforts should be made with respect to the expenditures.

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[17] See chapter 3.

[18] From the guaranties gorwth rate we excluded the guaranties issued for the borrowing of PE "Roads of Serbia" beacause these investments are already included in the consolidated balance of the general government and are therefore implicitly treated through the growth of public debt for the financing of deficit.

***The biggest tax policy measure for the short-term reduction of deficit would be to raise VAT.*** Tax reform would entail the increase of certain taxes on consumption (VAT, excise), elimination of exemptions and deductions within the corporate income tax, as well as the improvement of the tax administration with the aim to reduce the rate of tax evasion. Parallel to the tax increase, it would be economically justifiable to reduce the fiscal burden on labor and abolish a number of quasi-fiscal levies.

***We propose that in the beginning of the new Government term (effectively not later than in September) VAT is raised as an urgent measure of fiscal consolidation by four percentage points.*** This would mean that both VAT tax rates are raised – the standard rate from 18 percent to 22 percent and the lower rate from 8 percent to 10 percent. In addition, it is necessary to transfer 20 percent of (non-existential) products from the lower to the higher tax rate and increase the excise on tobacco products and alcohol beverages. In this way around 0.9 percent of GDP of additional tax revenues would be ensured as early as in 2012, and the deficit would be that much lower.

***For January 2013 we propose the continuation of comprehensive tax reform, primarily through reducing the fiscal burden on labor.*** The continuation of tax reform would include the following measures, the largest of which would be implemented from January 1, 2013: 1) reducing the contributions paid by the employer from 17.9 percent to 10 percent of the gross wage; 2) eliminating and limiting a number of quasi-fiscal levies; 3) eliminating exemptions and tax breaks within the corporate income tax, and 4) improvement of relevant legislation and collection of property tax. Net effect of the tax-related measures to be implemented in 2012 and 2013 would be the increase of tax revenues in 2013 by 1 percent of GDP compared to the scenario of not raising taxes (Tables 1.2 and 1.3), and these measures would also stop further shrinking of the share of tax revenues in GDP until 2016, which would result from the continued rebalancing of economy.[19]

***With respect to the budget expenditures, the key measure of the short-term fiscal consolidation would be the freezing of pensions and wages in October 2012 and in 2013.*** Given that the tax reform should not yield more than 1 percent of GDP, strong measures are needed on the expenditures side in order to achieve the necessary fiscal adjustment in 2013 (reduction of expenditures by additional 2 percent of GDP). Due to the volume of the necessary adjustment and the structure of Serbian public expenditures, the needed effects can only be accomplished through freezing (or even nominal reduction) of pensions and wages. Apart from the significant size of the savings, the freezing of pensions and wages is also economically justified due to the fact that Serbian structure of public expenditures differs from the similar countries mostly with respect to the large allocations for pensions and wages. In addition, the freezing of pensions and wages in October 2012 in 2013 would prevent the "second wave" of the inflation acceleration, which could result from a potential inflation increase caused by the increase of VAT, and this one-off increase of inflation is integrated into the level of pensions and wages through the regular October indexation. From the perspective of public finances, the integration of potential inflation into the pensions and wages could offset the stronger budget revenues with a significant increase of expenditures. A detailed overview of revenues and expenditures of the consolidated general government is

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[19] A good example of economy rebalancing can be the investment made by the company FIAT. When this company begins to operate fully GDP will increase, but the effects on the tax revenues will be much lower since the biggest part of the production is intended for exports (free of VAT), and the company is exempt from paying the corporate income tax in the next ten years. This is why the tax revenues will show a much slower growth than the GDP.

provided in Tables 1.2 and 1.3. We have presented the consolidated general government balance sheet with and without the short-term fiscal consolidation.

**Table 1.2 Consolidated General Government with and without Short-Term Fiscal Consolidation (RSD billion), 2011–2013**

| | 2011 | 2012 | 2013 | | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|---|
| | **Without short-term fiscal consolidation** | | | | **With short-term fiscal consolidation** | | |
| **I PUBLIC REVENUES** | **1.302.5** | **1.386.0** | **1.462.0** | | **1.302.5** | **1.415.0** | **1.490.5** |
| 1.1. Tax revenues | 1.130.9 | 1.187.0 | 1.270.4 | | 1.130.9 | 1.217.0 | 1.301.5 |
| Personal income tax | 150.8 | 160.0 | 171.1 | | 150.8 | 160.0 | 171.1 |
| Income tax | 37.8 | 54.0 | 56.8 | | 37.8 | 54.0 | 56.0 |
| VAT | 342.4 | 350.0 | 374.9 | | 342.4 | 377.0 | 475.0 |
| Excises | 170.9 | 180.0 | 193.2 | | 170.9 | 183.0 | 205.0 |
| Customs | 38.8 | 33.0 | 35.3 | | 38.8 | 33.0 | 31.0 |
| Other tax revenues | 43.5 | 45.0 | 48.4 | | 43.5 | 45.0 | 48.4 |
| Contributions | 346.6 | 365.0 | 390.6 | | 346.6 | 365.0 | 315.0 |
| 1.2. Non-tax revenues | 166.9 | 195.0 | 187.0 | | 166.9 | 195.0 | 185.0 |
| 2. Capital revenues | 2.0 | 1.0 | 1.0 | | 2.0 | 1.0 | 1.0 |
| 3. Grants | 2.6 | 2.0 | 2.0 | | 2.6 | 2.0 | 2.0 |
| | | | | | | | |
| **II PUBLIC EXPENDITURES** | **1.460.9** | **1.592,0** | **1.638,0** | | **1.460.9** | **1.578,0** | **1.598,0*** |
| 1. Current expenditures | 1.324.7 | 1.441.0 | 1.519.0 | | 1.324.7 | 1.437.0 | 1.481.0 |
| Expenditures for employees | 342.5 | 376.0 | 396.3 | | 342.5 | 374.0 | 383.0 |
| Procurement of goods and services | 247.0 | 254.0 | 266.0 | | 247.0 | 254.0 | 262.8 |
| Interest payment | 44.8 | 67.0 | 80.0 | | 44.8 | 67.0 | 79.0 |
| Subsidies | 80.5 | 97.0 | 91.0 | | 80.5 | 97.0 | 91.0 |
| Social benefits and transfers | 609.0 | 647.0 | 686.0 | | 609.0 | 645.0 | 665.0 |
| *of which: Pensions* | *446.3* | 480.0 | 507.0 | | 446.3 | 478.0 | 487.0 |
| *Other social benefits* | *162.7* | *167.0* | 178.9 | | 162.7 | 167.0 | 178.9 |
| 2. Capital expenditures | 111.2 | 140.0 | 142.0 | | 111.2 | 140.0 | 142.0 |
| 3. Net budget lending | 25.0 | 11.0 | 10.0 | | 25.0 | 11.0 | 10.0 |
| Unidentified measures by year | - | - | -33.0 | | - | -10.0 | -25.0 |
| **III CONSOLIDATED BALANCE (I-II)** | **-158.4** | **-206.0** | **-176.0** | | **-158.4** | **-163.0** | **-107.5** |
| ***pro memoria*** | | | | | | | |
| GDP | 3.175.0 | 3.317.9 | 3.554.1 | | 3.175.0 | 3.317.9 | 3.536.9 |
| GDP growth ( percent) | 1.6 | 0.0 | 3.0 | | 1.6 | 0 | 2.5 |
| Public debt ( percent of GDP) | 48.4 | 54.9 | 59.3 | | 48.4 | 53.7 | 55.8 |

* Unindentified measures of 10 bln RSD from the previous year are included.
Source: Fiscal Council (up to 2012 based on the Ministry of Finance data)

**Table 1.3 Consolidated General Government with and without Short-Term Fiscal Consolidation (percent of GDP), 2011–2013**

| | 2011 | 2012 | 2013 | | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|---|
| | Without short-term fiscal consolidation | | | | With short-term fiscal consolidation | | |
| **I PUBLIC REVENUES** | **41.0** | **41.8** | **41.1** | | **41.0** | **42.6** | **42.1** |
| 1.1. Tax revenues | 35.6 | 35.8 | 35.7 | | 35.6 | 36.7 | 36.8 |
| Personal income tax | 4.7 | 4.8 | 4.8 | | 4.7 | 4.8 | 4.8 |
| Income tax | 1.2 | 1.6 | 1.6 | | 1.2 | 1.6 | 1.6 |
| VAT | 10.8 | 10.5 | 10.5 | | 10.8 | 11.4 | 13.4 |
| Excises | 5.4 | 5.4 | 5.4 | | 5.4 | 5.5 | 5.8 |
| Customs | 1.2 | 1.0 | 1.0 | | 1.2 | 1.0 | 0.9 |
| Other tax revenues | 1.4 | 1.4 | 1.4 | | 1.4 | 1.4 | 1.4 |
| Contributions | 10.9 | 11.0 | 11.0 | | 10.9 | 11.0 | 8.9 |
| 1.2. Non-tax revenues | 5.3 | 5.9 | 5.3 | | 5.3 | 5.9 | 5.2 |
| 2. Capital revenues | 0.1 | 0.0 | 0.0 | | 0.1 | 0.0 | 0.0 |
| 3. Grants | 0.1 | 0.1 | 0.1 | | 0.1 | 0.1 | 0.1 |
| | | | | | | | |
| **II PUBLIC EXPENDITURES** | **46.0** | **48.0** | **46.1** | | **46.0** | **47.6** | **45.2*** |
| 1. Current expenditures | 41.7 | 43.4 | 42.7 | | 41.7 | 43.3 | 41.9 |
| Expenditures for employees | 10.8 | 11.3 | 11.2 | | 10.8 | 11.3 | 10.8 |
| Procurement of goods and services | 7.8 | 7.7 | 7.5 | | 7.8 | 7.7 | 7.4 |
| Interest payment | 1.4 | 2.0 | 2.3 | | 1.4 | 2.0 | 2.2 |
| Subsidies | 2.5 | 2.9 | 2.6 | | 2.5 | 2.9 | 2.6 |
| Social benefits and transfers | 19.2 | 19.5 | 19.3 | | 19.2 | 19.4 | 18.8 |
| *of which: Pensions* | 14.1 | 14.5 | 14.3 | | 14.1 | 14.4 | 13.8 |
| *Other social benefits* | 5.1 | 5.0 | 5.0 | | 5.1 | 5.0 | 5.1 |
| 2. Capital expenditures | 3.5 | 4.2 | 4.0 | | 3.5 | 4.2 | 4.0 |
| 3. Net budget lending | 0.8 | 0.3 | 0.3 | | 0.8 | 0.3 | 0.3 |
| Unidentified measures by year | - | - | -0.9 | | - | -0.3 | -0.7 |
| **III CONSOLIDATED BALANCE (I-II)** | -5.0 | -6.2 | -5.0 | | -5.0 | -4.9 | -3.0 |
| ***pro memoria*** | | | | | | | |
| GDP | 3.175.0 | 3.317.9 | 3.554.1 | | 3.175.0 | 3.317.9 | 3.536.9 |
| GDP growth ( percent) | 1.6 | 0.0 | 3.0 | | 1.6 | 0 | 2.5 |
| Public debt ( percent of GDP) | 48.9 | 54.9 | 59.3 | | 48.9 | 53.7 | 55.8 |

* Unindentified measures of 10 bln RSD from the previous year are included.
Source: Fiscal Council (up to 2012 based on the Ministry of Finance data)

***With the increase of VAT and freezing of pensions and wages, there is still around 0.3 percent of GDP that needs to be saved in order for the 2012 fiscal deficit to reach 5 percent of GDP, and the additional approximately 0.7 percent of GDP in 2013 for the deficit of 3 percent of GDP.*** Tables 1.2 and 1.3 show that the envisaged short-term measures (tax reform, freezing of pensions and wages) will not be sufficient for the accomplishment of the projected fiscal objectives (2012 and 2013 deficits of 5 percent of GDP and 3 percent of GDP).[20] For the achievement of the largest part of the necessary savings in 2012 we propose amendments to the Law on Financing the Local Government that would either completely revoke the amendments made in 2011 and bring back the central government share in the payroll tax to 60 percent or at least introduce a more just arrangement for the distribution of the payroll tax between the local government and the central government budget in the proportion of 50:50 percent instead of the current 80:20 percent. The net effect of this measure on the reduction of deficit in 2012 could reach about 0.2 percent of GDP, while in 2013 it would yield the additional 0.4-0.5 percent of GDP.[21] We believe that the possible remaining savings in 2012 and 2013 (there is still about RSD 3-5 billion of savings needed in 2012 and about RSD 10-15 billion in 2013) could be made through additional corrections of discretionary expenditures.[22]

***It is also necessary to prepare the (reserve) short-term measures for the possible additional aggravation of fiscal trends.*** We have already mentioned that there are risks of further widening of the fiscal deficit, primarily if the economic activity growth in 2012 is negative. This is why we believe that the new Government must also prepare the additional measures to be implemented under such conditions. One such measure would be the gradual execution of the tax reform, which would mean that instead of making one cut of tax burden on employment, this reduction is performed in several pre-defined phases starting from January 1, 2013. Another possible solution in the event of exacerbated fiscal conditions in 2012 is the nominal reduction of wages in the public sector and/or pensions, which would not be the only example of such measures in the region.

*Short-Term Consolidation without Raising Taxes*

We have already remarked that instead of the combination of raising taxes and freezing pensions and wages, it is possible to achieve the similar effect without raising taxes, but this would entail nominal reduction of pensions and wages. Here is a more detailed explanation.

Tables 1.2 and 1.3 indicate that the burden of the proposed model of fiscal consolidation for 2012 and 2013 is almost evenly distributed across: 1) tax reform, 2) freezing of pensions and wages, and 3) other discretionary expenditures (reducing subsidies and costs of goods and services). The savings (revenue increase) coming from all these sources should reach approximately 1 percent of GDP in order for the total deficit to fall by approximately 3 percent of GDP. This combination allows for the choice between freezing pensions and wages and increasing VAT.[23]

Our preliminary estimates show that if the authorities fail to increase taxes, there will have to be a nominal reduction of pensions and wages in 2012 by about 5 percent (instead of

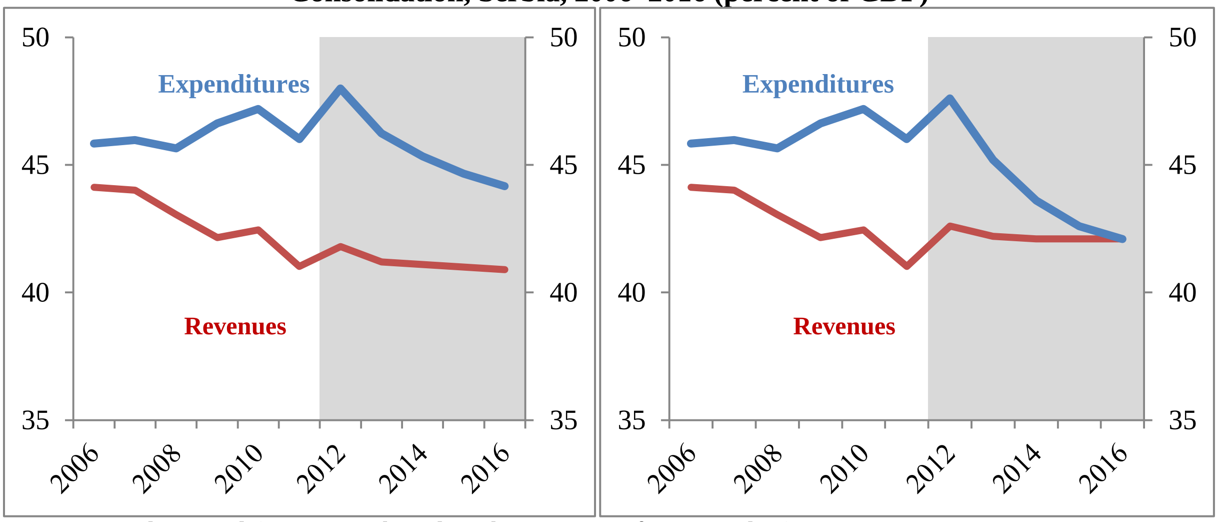
[20] There is a favorable circumstance in the fact that the share of subsidies in the GDP will be lower in 2013 by approximately 0.3 perecentage points, due to the completion of the government's obligation in the company FIAT Automobiles Serbia.
[21] See Chapter 10 – Fiscal Decentralization.
[22] See also chapters 6-11 which describe some possible short-term saving by individual budget expenditure items.
[23] The level of savings from discretionary expenditures cannot be higher than anticipated, both due to their low share in public expenditures and due to the timeframe necessary for the implementation of reforms of the existing systems that would result in such savings. In addition, even though laying off the excess workforce in the public sector is an often quoted possibility, it is not feasible in the short run. See Chapter 7 – *Reform of the Wage and Employment System in Government Sector*.

raising VAT by 2 percentage points). The nominal reduction will actually have to be even more than 5 percent if the reduction would not apply to the employees and pensioners with the minimal/lowest income. The Fiscal Council proposes to make the necessary fiscal consolidation through the combination of raising taxes and freezing wages and pension. However, given that the similar effects could also be achieved through the nominal reduction of pensions and wages, the government may decide between the two options.

### 1.5. Medium-Term Savings Measures

***Mid-term fiscal objective should be the further reduction of deficit over the period 2014-2016 until reaching the balanced budget ie, 0 percent deficit in 2016.*** This means that in the period 2014–2016 the fiscal deficit should be reduced by 3 percent of GDP – which is the level of deficit projected for the beginning of 2014. The necessity of significantly cutting the deficit even after the short-term fiscal consolidation to be performed in 2012 and 2013 arises from the trend of public debt, as well as the need to prevent the public debt crisis and reduce the public debt level as close to the 45 percent limit as possible (Graph 1.2). For this reason, in addition to the short-term fiscal consolidation (item 1.4) which is to take place immediately after the new Government is formed, it is necessary to begin the preparation of a number of systemic reforms whose implementation would begin in 2013 and the fiscal effects would be visible in the period 2014–2016.

**Graph 1.5 Projections of Tax Revenues and Expenditures Without and With Fiscal Consolidation, Serbia, 2006–2016 (percent of GDP)**




Source: Fiscal Council (up to 2012 based on the Ministry of Finance data)

***Medium-term reduction of fiscal deficit would be achieved through public expenditure cuts.*** It is economically justified to implement the necessary adjustment of the fiscal deficit through the interventions on the expenditures side, as their share in GDP is too high (in 2012 over 47 percent of GDP),[24] instead of increasing public revenues. For this reason the main revenue boosting results of the tax reform should be achieved in the short term, while in the mid-term the tax reform should ensure the maintenance of the stable share of public revenues in GDP. Therefore, during the period 2014–2016 the share of expenditures

[24] Once again, we must express our reservation with respect to the extremly high share of public expenditures in the GDP since it is possible that the GDP value is somewhat underestimated.

in GDP will have to be reduced by three percentage points. Graph 1.5 shows the projection of the share of public revenues and expenditures in GDP with and without the (necessary) fiscal consolidation.

***When reducing the share of total public expenditures in GDP, it is important to significantly increase the level of public investment.*** The level of public investments in Serbia, which stood at around 3.5 percent of GDP in the previous three years, is not enough to support a sustainable economic growth. For this reason, we believe that the share of investments in GDP should be raised in the medium term to 5 percent of GDP, from 4 percent of GDP envisaged for 2012. It will probably be possible to maximize this share in 2013 as well. It is therefore necessary to make even larger mid-term savings in the current expenditures. In the total reduction of public expenditures at the level of 3 percent of GDP to be executed from 2014 to 2016, the share of current public expenditures should be reduced by 4 percent of GDP in order to release an additional 1 percent of GDP for the increase of investments.

***A portion of the reduction of public expenditures to be implemented in 2014-2016 will be carried out through the statutory indexation of pensions and wages (about 2 percent of GDP), and another portion will come as the result of reforms.*** Short-term consolidation plan would set out the freezing of pensions and wages in October 2012 and over 2013, with potential exclusion of the socially most disadvantaged categories (minimum pension/wages). Following this measure, the statutory indexation would continue (special fiscal rules, Budget System Law). According to the special fiscal rules, wages in the public sector are indexed twice a year. The wage bill will grow according to the growth rate of consumer prices increased by half of the previous year's growth. Average pensions will grow according to the growth rate of consumer prices increased by the previous year's GDP growth over 4 percent. During 2014-2016, the share of pensions and wages in GDP would thus decrease by 2 percent of GDP relative to 2013, which means that there is still around 2 percent of GDP of savings to be made in other current expenditures (procurement of goods and services, subsidies, social benefits).

***It is necessary to carry out a reform of the pensions system that would make the system more just and sustainable.*** Allocations for pensions make up most of the public expenditures (about 30 percent of all spending). Their share in the Serbian GDP is larger than in other countries, which is why they should be permanently reduced to a sustainable level.[25] Revenues of the Pension Insurance Fund cover only about 50 percent of the expenditures for pensions, while the rest of the necessary resources is covered by a transfer from the Republic budget. As a possible direction of the medium term pension reform, we proposed the introduction of the system of actuarial equalizing factors for early retirement, raising the retirement age for women and modification of the retirement age in line with the longer life expectancy. The savings to be made in this way until 2016 reach up to 0.2 percent of GDP (if the reform came into effect in 2013). Even though the level of savings to be made by 2016 does not seem too big, one should bear in mind that the actual fiscal savings that would result from the pension reform are not made in the medium, but in the long term, and that the proposed steps need to be made now in order to achieve a permanent improvement of the system (which will be fully evident only in 10 to 15 years). When it comes to the other social benefits, we believe they should be excluded from the public expenditures reduction, i.e. that their share in GDP should be preserved more or less as it is, until the fiscal consolidation

[25] See Chapter 6 – *Fiscal Sustainability of Serbian Pension System*.

process is completed, together with the reforms which will enable sufficient level of the economic growth and employment.

***Reform of the wage and employment system could yield savings of approximately 0.4 percent of GDP until 2016.*** Similarly to pensions, the share of expenditures for wages in GDP is too high. The main reason for this is the extremely high level of wages in the government sector relative to the productivity of the Serbian economy and the level of wages in the private sector. Several studies have shown that there is a surplus of workforce in certain parts of the government sector. The reform of the wage and employment system that we propose would include the introduction of the common system of wage levels for all public servants,[26] downsizing of workforce in the local government, reduction of non-medical staff in healthcare and of the excess number of teachers in the primary education.[27] The expected savings from these measures could reach about 0.4 percent of GDP until 2016.

***Over the period 2014-2016, the reform should reduce the share of direct subsidies in GDP by approximately 0.6 percent of GDP***.[28] However, for the purpose of achieving these savings, it will be necessary to implement a reform of the local and state-owned public enterprises, reduce and gradually terminate subsidies for investments and employment and instead carry out the reforms that would improve the business environment. The additional subsidy-related reforms pertain to the change in the structure and mechanisms of granting subsidies to railways company and the improvement of the system of subsidizing agriculture with the aim to stimulate productivity improvements in this sector. Savings to be made on the basis of indirect subsidies would also be significant, even though they do not affect the consolidated general government balance. Above all, savings that can be made in this respect are those related to the linking the years of service, subsidies granted through off-budget institutions (such as Development Fund), as well as subsidies provided through other funds and agencies.

***One portion of the remaining necessary savings can be achieved through the savings in the procurement of goods and services.*** The remaining savings that need to be made in the medium term (apart from the indexation and reforms of pensions, wages and subsidies) equal about 0.8 percent of GDP.

Necessary savings can be made in the other discretionary expenditures – procurement of goods and services.[29] However, it should also be noted that, contrary to the common belief, the procurement of goods and services provides very limited possibilities for savings. Large portion of the expenditures for goods and services is essentially not even discretionary. Procurement of goods and services includes the costs of electricity and other bills, and the specialized services are used for the payment of wages to scientific workers for the fundamental research in sciences. Additional limitation comes from the fact that the biggest portion of the procurement is performed outside central government budget – through the Health Fund, local governments, even agencies and off-budget funds. This is why certain savings in the purchase of goods and services can be made directly – through the

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[26] When introducing a common system of wage levels, the authorities must not allow for any fiscal costs of harmonizing all the levels. This means that the authorities should reduce those wages that significantly deviate from the common wages for the same or similar post in the public service.

[27] See Chapter 7 – *Reform of the Wage and Employment System in Government Sector.*

[28] Subsidies actually allow for significant short term savings. See Chapter 9 – *Analysis of Potential Savings on Subsidies.*

[29] If we exclude public investments that are necessary for a country's economic growth (which does not mean that thier efficiency should not be improved) and part of subsidies where we already quantified savings, the only item remaining is the procurement of goods and services where the government can reduce expenditures with discreationary measures, without changing legal framework and cancelling the obtained rights.

improvement of the public procurement system, but it can also be done indirectly – through the improved efficiency of local government authorities and more favorable business environment on the local level[30], as well as more efficient functioning of government agencies and extra-budgetary funds.[31] We estimate that the total medium term savings that can be achieved in the field of goods and services procurement at approximately 0.5-0.7 percent of GDP.

***The remaining reduction of public expenditures, of approximately 0.2 percent of GDP over the period 2014-2016, will be accomplished through the reduction of interest payments.*** By introducing short and medium-term measures of fiscal consolidation, the debt-to-GDP ratio will decrease from approximately 56 percent of GDP to around 48 percent of GDP. This will automatically lead to the lower allocation of funds for the payment of interests (Table 1.4). However, we wish to stress that the fiscal consolidation and the return of the Serbian public finances on the sustainable path would also bring about the reduction of interest rates on the government borrowing, which consequently reduces the expenditures for the payment of interest.

Table 1.4 illustrates possible trends of revenues and expenditures up to 2016. The table also includes planned fiscal savings arising from reforms.

***The reforms will also ensure the necessary change in the structure of public expenditures.*** The structure of the Serbian public expenditures in 2012, as well as the possible structure of public expenditures in 2016 – following the implementation of the proposed reforms – is presented in Graph 1.6. Here we can see the desirable growth in the investment spending, as well as the reduced spending on pensions and wages (which represent the main driver of the budget deficit). The said graph also indicates that it is impossible to achieve any significant savings in the discretionary expenditures. Namely, we used different colors to present the expenditures that are defined by laws and cannot be significantly affected by the government policy unless the legislation is amended or certain entitlements are abolished (wages, pensions, other social benefits and interests). These expenditures are divided from those that are essentially discretionary – investments, subsidies and procurement of goods and services.[32] We can see from both graphs that by far the biggest portion of public expenditures is used for the statutory items and that the necessary savings will not be possible without a significant contribution from these expenditures (to give an illustrations – necessary medium-term savings of 4 percent of GDP are larger than the total allocation for subsidies, and are also bigger than half the allocation for the procurement of goods and services).

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[30] See Chapter 10 – *Fiscal Decentralization.*

[31] See Chapter 11 – *Own-Source Revenues of Budget Beneficiaries and Extra-budgetary Funds.*

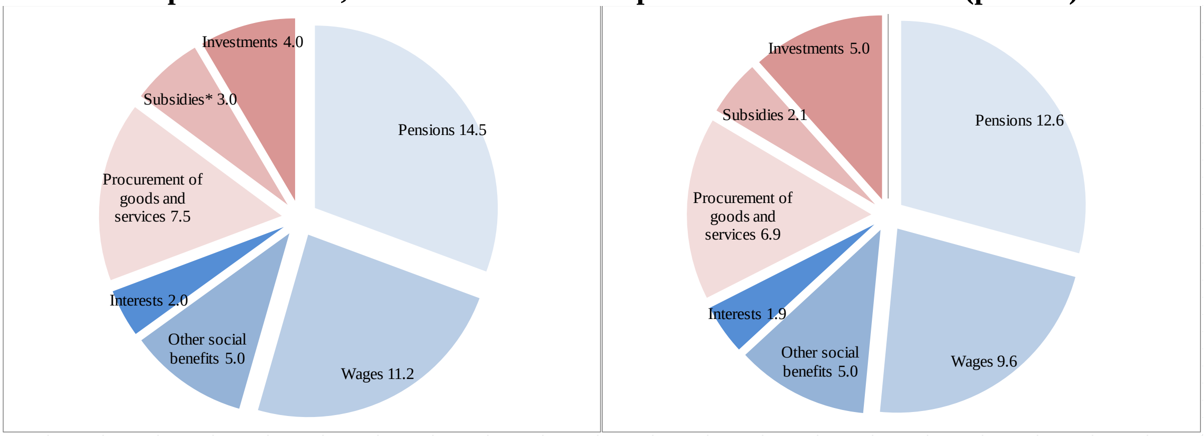
[32] A detailed analysis shows that the biggest part of these expenditures cannot be affected without comprehensive reforms.

**Table 1.4 Serbia, Fiscal Consolidation and Mid-Term Reforms Scenario 2012–2016**

| | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|
| | percent of GDP | | | | |
| **I PUBLIC REVENUES** | **42.6** | **42.1** | **42.0** | **42.0** | **42.0** |
| 1.1. Tax revenues | 36.7 | 36.8 | 36.8 | 36.9 | 36.8 |
| Personal income tax | 4.8 | 4.8 | 4.8 | 49 | 4.9 |
| Income tax | 1.6 | 1.7 | 1.8 | 1.9 | 1.9 |
| VAT | 11.4 | 13.3 | 13.2 | 13.1 | 13.0 |
| Excises | 5.5 | 5.8 | 5.8 | 5.8 | 5.8 |
| Customs | 1.0 | 0.8 | 0.7 | 0.6 | 0.6 |
| Other tax revenues | 1.4 | 1.4 | 1.4 | 1.4 | 1.4 |
| Contributions | 11.0 | 9.0 | 9.2 | 9.3 | 9.3 |
| 1.2. Non-tax revenues | 5.9 | 5.1 | 5.0 | 4.9 | 4.9 |
| 2. Capital revenues | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| 3. Grants | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 |
| | | | | | |
| **II PUBLIC EXPENDITURES** | **47.6** | **45.2** | **43.5** | **42.5** | **42.0** |
| 1. Current expenditures | 43.3 | 41.9 | 40.1 | 38.9 | 38.0 |
| Expenditures for employees | 11.3 | 10.8 | 10.2 | 9.8 | 9.6 |
| Procurement of goods and services | 7.7 | 7.4 | 7.2 | 7.0 | 6.9 |
| Interest payment | 2.0 | 2.2 | 2.1 | 2.0 | 1.9 |
| Subsidies | 2.9 | 2.6 | 2.3 | 2.1 | 2.0 |
| Social benefits and transfers | 19.4 | 18.8 | 18.4 | 18.0 | 17.6 |
| *of which: Pensions* | 14.4 | 13.8 | 13.2 | 12.9 | 12.6 |
| *Other social benefits* | 5.0 | 5.1 | 5.1 | 5.1 | 5.0 |
| 2. Capital expenditures | 4.2 | 4.0 | 4.2 | 4.5 | 5.0 |
| 3. Net-lending | 0.3 | 0.3 | 0.2 | 0.2 | 0.1 |
| **Unidentified measures (cumulatively)** | **-0.3** | **-1.0** | **-1.0** | **-1.0** | **-1.0** |
| **III CONSOLIDATED BALANCE (I-II)** | **-4.9** | **-3.0** | **-1.5** | **-0.5** | **0.0** |
| | | | | | |
| **pro memoria** | | | | | |
| Contribution of reforms to deficit reduction (annual) | - | - | 0.7 | 0.6 | 0.5 |
| GDP | 3.317.9 | 3.536.9 | 3.788.7 | 4.137.2 | 4.517.9 |
| GDP growth ( percent) | 0 | 2.5 | 3 | 5 | 5 |
| Public debt ( percent of GDP) | 53.7 | 55.8 | 54.4 | 51.7 | 48.6 |

Source: Fiscal Council

**Graph 1.6. Serbia, Structure of Public Expenditures 2012 and 2016 (percent)**




* Subsidies include net-lending.
Source: Fiscal Council

***An important aspect of the fiscal consolidation and implementation of reforms is to lay the foundation for a strong and sustainable economic growth.*** Reforms of public spending are not only needed because of the expected fiscal effects. Most of the envisaged reforms would certainly have a positive effect on the economic growth and better quality of life in Serbia. Fiscal consolidation will enable a more favorable funding of economy since the reduction of public debt will lead to the decrease of the country's risk premium, and the change in the structure of the public consumption towards the greater share of investments will directly bring about a more rapid economic growth due to the fact that public investments have a greater multiplier than the current spending. Reduction of fiscal deficit and public debt will also result in the fall of the trade deficit, as well as the stabilization of the dinar exchange rate. Implementation of the proposed reforms will have a positive effect on the economic growth through the improvement of the business environment, stimulating the private sector development, shifting the economic orientation from spending to exports, strengthening competition due to the effects of the fiscal devaluations, establishing a predictable business environment, etc.

***The implementation of reforms should start as early as in 2013, which is why they must be carefully prepared in 2012.*** The reforms should yield the biggest fiscal effects in 2014 and 2015 (Table 1.4 – Contribution of reforms). For this to happen, the implementation of reforms must begin in early 2013 at the latest, since the first sizeable fiscal savings will require at least a year. For this reason, in the following chapters we analyze the possibility of implementing certain reforms, propose directions to be taken, and provide the assessment of potential savings, where possible.

***It is also necessary to consider possible additional measures that would be implemented in the event of the prolonged recession in EU.*** The assumptions underpinning our fiscal framework for 2014 – 2016 envisage that the reforms and fiscal consolidation will enable a relatively high economic growth rate of approximately 5 percent up to 2015. The factor that can greatly affect this projection, and which cannot be influenced by the government and its economic policies, is the economic growth in EU, which is closely linked with our economy. Should the recession in EU persist, the projected growth rates in Serbia might not be achieved, which can lead to the failure to reduce the deficit and public debt, as planned. Considering that the fiscal policy priority will be to avoid the public debt crisis, the government must be ready to continue with the restrictive short-term measures in the event of negative developments in Europe. These restrictive measures imply the prolonged freezing of pensions and wages, additional increase of certain taxes in line with the latest EU practice, etc.

*Fiscal Consolidation and Public Sector Reforms*

In order to achieve the planned reduction of the public consumption relative to GDP, it is necessary to make the sector strategies (for education, healthcare, defense, science, culture, subsidies - agriculture, public investments, etc.) consistent with the planned cuts of the total government spending. Almost all the sector strategies have a tendency of stating that one of its key objectives is to increase the share of expenditures for that area in GDP. If the share of expenditures for all areas increased, that would result in the significant rise of public expenditures relative to GDP compared to the current, already high level.

In the previous part of this chapter we have provided detailed projections of the consolidated revenues and expenditures according to economic classification which are in line with the aforementioned public consumption ceiling of 42 percent of GDP.[33] According to these projections, the largest savings are supposed to be achieved in the expenditures for pensions, wages and subsidies. However, the general framework for government spending should include expenditures for all government functions: general public services, defense, national security, economic affairs, social benefits, pensions, healthcare, education, science, housing and utilities, culture, religion, ecology, etc. Balance consistency implies that the expenditures by government functions are also reduced to 42 percent of GDP in the following four years. This means that fiscal consolidation envisages that the share of expenditures for the majority of the above sectors will be reduced or stay the same. However, the growth of GDP would enable the real increase of most of the expenditures in the medium term (three to four years) but more slowly than the GDP growth.

Considering the government functions, the largest savings are supposed to be realized in the area of pensions (savings of 1.8 percentage points of GDP), as pensions make up by far the greatest part of the social security sector. The second largest savings are to come from wages – 1.7 percent of GDP, which will be equally divided across all government sectors. Considering the structure of staff, the biggest wage-related savings would be made in education, healthcare, security services and local and central government administration, i.e. sectors with the largest number of staff. Savings for the procurement of goods and services, which would be achieved mainly through the improvement of the public procurement system, could reach about 0.5 percent of GDP without reducing the quality of public services. Broken down by functions, the largest savings in the procurement of goods and services would be made in the sectors that are their biggest users: healthcare, police, army, education, etc. In order for the reduction of expenditures for wages and purchase of goods and services to contribute to the reduction of the overall public expenditures, but also the spending on individual government functions, it is necessary to avoid using these savings for the increase of other expenditures within certain functions.

When it comes to the economic affairs of the government, their share in GDP would mostly remain the same, but their structure would change significantly: share of public

[33] We wish to reiterate that after the GDP calculation is brought in line with the international methodology, Serbian GDP will increase by approximately 10 percent, which will consequently reduce all the numerators that have the GDP as their denominator. In that case the sahre of public consumption in GDP would equal approximately 38 percent instead of 42 percent. However, if all forms of consumption (that are not covered now) were included in the consolidated general government balance, the share of public consumption would probably be close to 40 percent of GDP according to the new calculation methodology.

investments in GDP would increase by around 1 percent of GDP, while the share of subsidies, including net lending, would be reduced for approximately the same percentage. Budget allocations for housing and utilities could be reduced primarily through the decrease of subsidies to local utility companies (0.3 percent of GDP). Some additional savings would be achieved by merging, consolidating or eliminating certain extra-budgetary institutions (0.2 percent of GDP). Even though allocations for certain government functions (environment, culture, science) are quite modest, in the next four years the allocations for these purposes can only increase as the result of the GDP growth.

## 2. SERBIA'S PUBLIC DEBT AND ITS SUSTAINABILITY

**Recent Developments and Issues**

Over the past four years, the Serbian public debt has been rapidly growing, exceeding the statutory limit of 45 percent of GDP in 2011 and reaching around 55 percent of GDP in 2012. The systemic factors fuelling public debt have not been removed (fiscal deficit, guarantees), which is why the growth of public debt relative to GDP will continue in the future if the fiscal consolidation is not implemented. Serbia is already in the zone where the probability of public debt crisis is not small. Every additional increase of the public debt relative to GDP raises this probability – if the authorities fail to make an arrangement with the IMF this could be the trigger that could set off the public debt crisis in Serbia.

**Proposed Measures**

1. In the short term: preserving the existing legal framework that limits the maximum debt-to-GDP ratio to 45 percent (restitution debt excluded), and stipulates that the structural fiscal deficit is 1 percent of GDP. In addition, it is necessary to introduce a clear and precise legal definition of the public debt coverage, as well as the manner of calculating the debt-to-GDP ratio.
2. In the medium term, improve the legal framework by:
    - harmonizing the rules on structural fiscal deficit with the EU rules;
    - introducing a set of successive public debt limits that would automatically obligate the government to carry out pre-defined measures for curbing public debt.
3. Major public debt curbing measures are the following:
    - sharp reduction of fiscal deficit in 2013 to approximately 3 percent of GDP and reaching balanced budget by 2016;
    - limiting the growth rate of government guarantees to 2 percentage points of GDP in the following four years, i.e. maximum 0.6 percentage points of GDP annually.

**Expected Effects**

Fiscal consolidation would significantly slow down the spiraling public debt in 2013, halting the growth in 2014. After that the debt-to-GDP ratio (excluding the temporary surge of liabilities based on restitution in 2015) would begin to fall. In the medium term, after 2016, Serbian public debt would stabilize at the level of 35-40 percent of GDP. Fiscal consolidation that would reduce the structural fiscal deficit, and consequently remove the systemic reasons of the public debt growth, would also significantly diminish the risk of public debt crisis breaking out in Serbia, which would lead to the creation of the favorable environment for the economic growth.

***Public debt in Serbia grew by EUR 5.7 billion during 2008-2011, while its share in GDP rose by 17.5 percentage points***. In 2011, public debt exceeded the statutory limit of 45 percent of GDP while in 2012 it is expected to grow further, exceeding the level of 55 percent of GDP by the end of the year. The main generator of the public debt growth is the sizeable total and primary fiscal deficit that, unlike other European countries, shows no downward trend. The Serbian fiscal deficit is predominantly of structural nature, which means that it is a consequence of the systemic imbalance between the taxes and public consumption policy, and not the result of cyclical factors. If the fiscal deficit is not reduced significantly and abruptly, the rapid growth of public debt will continue in the years to come. Serbia is already in the zone where the probability of public debt crisis is not small and every additional increase of the public debt relative to GDP increases this probability. Should the authorities fail to make an arrangement with the IMF, this could trigger the public debt crisis in Serbia. The existing legal framework that limits the maximum debt-to-GDP ratio to 45 percent and stipulates that the structural fiscal deficit is limited to 1 percent of GDP is deemed appropriate for Serbia. In the medium term, the legal framework could be improved by harmonizing the structural deficit limit with the EU rules. In addition, it would be advisable to implement a set of successive public debt limits that would automatically force the government to implement relevant measures (freezing of pensions and wages, freezing of total government spending, etc.). The most important measures for halting the spiraling public debt are the reduction of fiscal deficit and the limitation on the issuance of government guarantees. If these measures were applied, the growth of public debt would be stopped in 2014 at the level of around 55 percent of GDP, and after that its ratio to GDP would start to fall.

### 2.1. Current Situation and Issues

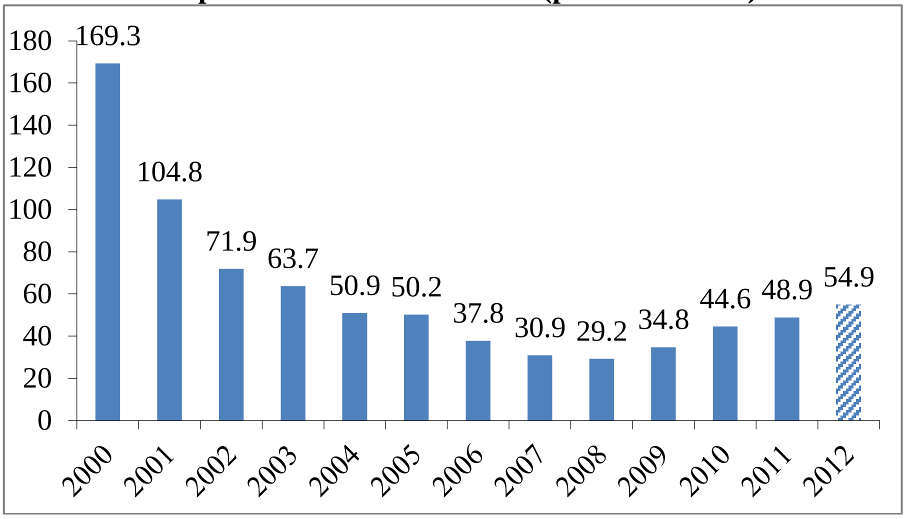
***Over the previous 12 years there were two distinctly different phases of the Serbian public debt evolution.*** From 2001-2008 the absolute level of the Serbian public debt was declining, as well as the share of public debt in GDP. The second period is characterized by a relatively rapid growth of the absolute public debt level, as well as its share in GDP. From the end of 2000 until the end of 2008, the Serbian public debt was reduced by approximately EUR 5.4 billion or by 38 percent – presented in Graph 2.1. The main factors causing the fall of the absolute public debt level over the period 2001-2008 are a relatively large write-off of the public debt towards Paris and London Club of creditors and the regular repayment of liabilities falling due (only on the basis of the frozen foreign currency savings an annual repayment equaled about EUR 250 million). This was primarily funded from the privatization proceeds. These proceed were also used for covering fiscal deficit, which is why the government did not borrow intensively despite running a fiscal deficit every year, except in 2005. During this period, Serbia received large grants and donations which were also used for covering government deficit. The decline of the debt-to-GDP ratio in the period 2001-2008 was even more rapid, due to the fact that in addition to the dropping absolute value of public debt, GDP showed a fast real growth (about 5 percent a year) and the high real appreciation of the dinar increased the value of GDP (against euro) and thus reduced the debt-to-GDP ratio (during this period almost the entire debt was foreign currency denominated).

***Since the outbreak of the economic crisis, the absolute level of public debt, as well as its share in GDP, is on the rise.*** From the end 2008 to the end 2011, Serbian public debt grew by EUR 5.7 billion, or approximately 65 percent, while its share in GDP rose by 17.5 percentage points.[34] The main factor fuelling the public debt in 2009-2011 is the relatively

[34] Considering the statutory coverage of the Serbian public debt, there is a gap between the Public Debt Law and the Budget System Law, and neither of the two is harmonized with the EU methodology. In early 2012 Fiscal Council proposed the modification of the public debt measuring methodology, as well as specifying the manner of calculating debt-to-GDP ratio (see: Fiscal Council [2012]).

large fiscal deficit which was mostly financed by borrowing instead of privatization proceeds, as was the case in the previous period.

**Graph 2.1 Serbian Public Debt (percent of GDP)**




Source: Fiscal Council

**Table 2.1 Movement of Serbian Public Debt (EUR bln)**

| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | Q1 2011 | Q2 2011 | Q3 2011 | Q4 2011 | Q1 2012 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| I. Total direct liabilities | 14.17 | 13.43 | 11.38 | 10.80 | 9.33 | 9.62 | 8.58 | 8,03 | 7.85 | 8.46 | 10.46 | 11.01 | 11.58 | 12.62 | 12.36 | 12.46 |
| Internal debt | 4.11 | 3.87 | 4.15 | 4.24 | 4.07 | 4.26 | 3.84 | 3.41 | 3.16 | 4,05 | 4.57 | 5.30 | 5.64 | 5.65 | 5.12 | 5.33 |
| External debt | 10.06 | 9.56 | 7.23 | 6.56 | 5.27 | 5.36 | 4.75 | 4.62 | 4.69 | 4.41 | 5.89 | 5.72 | 5.94 | 6.98 | 7.24 | 7.14 |
| II. Contingent liabilities | - | 0.00 | 0.15 | 0.22 | 0.34 | 0.66 | 0.80 | 0.85 | 0.93 | 1.39 | 1.71 | 1.68 | 1.71 | 2.12 | 2.11 | 2.15 |
| III. Total public debt (I+II)* | 14.17 | 13.43 | 11.53 | 11.02 | 9.68 | 10.28 | 9.38 | 8.88 | 8.78 | 9.85 | 12.17 | 13.00 | 13.59 | 15.04 | 14.77 | 14.92 |
| Public debt/GDP – assess.** | 169 | 105 | 73 | 66 | 55 | 52 | 38 | 31 | 29 | 35 | 45 | 45 | 46 | 48 | 49 | 50 |

*) According to the Public Debt Law, public debt of the Republic arises from the agreements concluded by the Republic, securities, the agreements rescheduling earlier liabilities of the Republic, securities issued according to a special law, debt of the Republic stemming from the issued government guarantees or on the basis of the direct taking over of the liabilities in the capacity of the borrower for the settlement of the liabilities arising from the government guarantee or counter-guarantee, issued by the Republic, local government debt guaranteed by the Republic. Local government debt is included since 2011.
**) Fiscal Council estimate (the basis for comparison is the sum of the nominal GDP in the current and three previous quarters)
Source: Fiscal Council

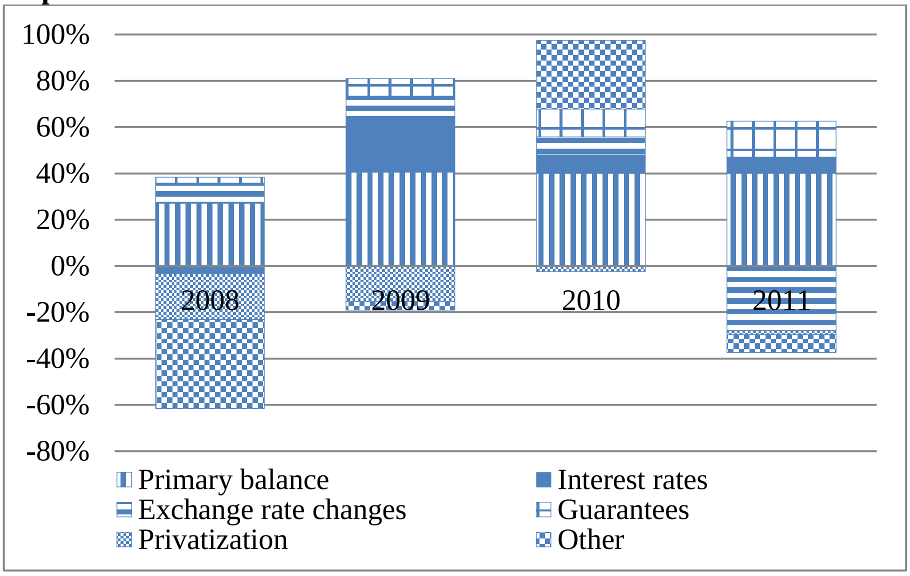
Graph 2.2 shows how much individual factors contributed in the change of the debt-to-GDP ratio over the period 2008-2011. The most significant and persistent one was the primary fiscal deficit.[35] Over the analyzed four years, the primary fiscal deficit equaled 3.1 percent of GDP on average. If all the other factors had zero effect on the public debt, the share of public debt in GDP would increase by 12.4 percentage points in the said four years. This means that the primary fiscal deficit accounted for approximately 70 percent of the growing share of public debt in GDP, if other conditions remain the same. The other important factor that caused the growth of public debt in this period was the level of government guarantees whose average annual growth rate over this period participated in GDP with approximately 0.8 percent. Their cumulative impact on the public debt growth equaled 3.2 percent of GDP,

[35] Primary fiscal deficit equals total fiscal deficit minus interest payments on the debt.

which means that the growth of guarantees accounted for around 18 percent of the growing public debt share in GDP. It is important to note that the impact of the guarantees on the public debt growth has been increasing in the previous four years (see the next chapter on guarantees). This leads us to the conclusion that the dominant factors that affected the growing share of debt in GDP were the two factors directly controlled by the government – primary fiscal deficit and the guarantees, which account for nearly 90 percent of the spiraling debt-to-GDP ratio. Similarly, the ratio was affected by the difference between the real interest rates and the GDP growth rate. If the period 2008-2011 is viewed as a whole, the changes in the real exchange rate did not affect the debt-to-GDP ratio. The effects of the real depreciation in 2008-2011 on the growing debt-to-GDP ratio were entirely neutralized by the dinar appreciation during 2011.

***In some years, the debt-to-GDP ratio was significantly affected by the extraordinary events which are independent of the deficit.*** However, when considering the analyzed period as a whole, the effects of these factors are mostly nullified, i.e. their net impact on the lower debt-to-GDP ratio equaled 1.2 percentage points. The most important extraordinary events causing the reduction of public debt are the write-off of the Kosovo debt to The World Bank in 2008 in the amount of approximately EUR 400 million, as well as the public debt decline by around EUR 380 million in 2010 due to the settlement of SFRY debt towards several Arab countries. Privatization proceeds played a significant role in slowing down the spiraling debt-to-GDP ratio, but only in 2008 when these proceeds were used for funding most of the fiscal deficit.

**Graph 2.2 Contribution of Individual Factors to the of Debt-to-GDP Ratio**




Source: Fiscal Council

***Similarly to Serbia, EU countries also experienced a major growth of the debt-to-GDP ratio during the crisis years.*** In the Eurozone member states the share of public debt in GDP grew on average by 21.7 percentage points during 2007-2011, while in all EU member states over the same period saw the increase of the debt-to-GDP ratio by 24 percentage points. In Serbia, the growth rate of public debt relative to GDP stood between 16 and 18 percentage points of GDP over the same period, depending on whether all or half of the government guarantees are included presented in Table 2.2. However, it is more relevant for Serbia to compare the growth of public debt with the new EU member states and Croatia. In these 11 states, the un-weighted average growth rate of the debt-to-GDP ratio during 2007-2011 was

15.2 percent, which is close to the Serbian public debt growth rate in the same period, measured according to the comparative methodology.

**Table 2.2 Movement of Public Debt during Crisis (percent of GDP)**

| | 2007 | 2011 | Change | | 2007 | 2011 | Change |
|---|---|---|---|---|---|---|---|
| Belgium | 84.1 | 98.0 | 13.9 | Bulgaria | 17.2 | 16.3 | -0.9 |
| Germany | 65.2 | 81.2 | 16.0 | Czech Republic | 27.9 | 41.2 | 13.3 |
| Estonia | 3.7 | 6.0 | 2.3 | Denmark | 27.5 | 46.5 | 19.0 |
| Ireland | 24.8 | 108.2 | 83.4 | Latvia | 9.0 | 42.6 | 33.6 |
| Greece | 107.4 | 165.3 | 57.9 | Lithuania | 16.8 | 38.5 | 21.7 |
| Spain | 36.2 | 68.5 | 32.3 | Hungary | 67.1 | 80.6 | 13.5 |
| France | 64.2 | 85.8 | 21.6 | Poland | 45.0 | 56.3 | 11.3 |
| Italy | 103.1 | 120.1 | 17.0 | Romania | 12.8 | 33.3 | 20.5 |
| Cyprus | 58.8 | 76.6 | 17.8 | Sweden | 40.2 | 38.4 | -1.8 |
| Luxembourg | 6.7 | 18.2 | 11.5 | Great Britain | 44.4 | 85.7 | 41.3 |
| Malta | 62.3 | 72.0 | 9.7 | **EU** | **59.0** | **83.0** | **24.0** |
| Holland | 45.3 | 65.2 | 19.9 | Croatia | 32.5 | 45.7 | 13.2 |
| Austria | 60.2 | 72.2 | 12.0 | Serbia | 30.9 | 48.9 | 18.0 |
| Portugal | 68.3 | 107.8 | 39.5 | Serbia* | 29.4 | 45.4 | 16.0 |
| Slovenia | 23.1 | 47.6 | 24.5 | | | | |
| Slovakia | 29.6 | 43.3 | 13.7 | | | | |
| Finland | 35.2 | 48.6 | 13.4 | | | | |
| **Eurozone** | **66.3** | **88.0** | **21.7** | | | | |

* Only 50 percent of guarantees included
Source: EC (2012), *European economic forecast - spring 2012*, except for Serbia

***However, unlike Serbia, since the beginning of crisis most EU countries significantly reduced both the total and the primary fiscal deficit as the main generators of public debt growth.*** Over the first two years of the crisis, the fiscal deficit in Serbia was even somewhat smaller than the EU as a whole or the new EU member states. But, in 2011 most member states made a sharp reduction of their primary deficit, while in Serbia it remained the same. According to the forecasts of the European Commission published in the spring of 2012 and made on the basis of the adopted national budgets, etc, most EU member states plan to additionally cut the primary fiscal deficit in 2012, while in Serbia it has worsened markedly at the beginning of 2012. We can conclude from the above that by reducing the primary fiscal deficit, most EU member states[36] have eliminated the main factor for the increase of debt-to-GDP ratio, which is not the case with Serbia.[37] Therefore, it is estimated that, if the strong fiscal consolidation is not implemented in Serbia, the debt-to-GDP ratio will continue to grow, as long as the market is willing to finance the government.

[36] Croatia gives an interesting example: on the basis of the budget and plans adopted in late 2011, it projected a large consolidated fiscal deficit in 2012, but following the budget revision in Q1 it reduced its deficit to 3.8 percent of GDP.

[37] In heavily indebted countries such as Greece, Italy, etc, the halting of spiraling public debt requires the primary fiscal surplus since the interest payment costs are very high in such countries.

**Table 2.3 Primary Fiscal Deficit as percent of GDP**

| | 2009 | 2010 | 2011 | *2012, forecast* |
|---|---|---|---|---|
| EU | -4.2 | -3.8 | -1.5 | *-0.5* |
| Eurozone | -3.5 | -3.4 | -1.1 | *0.0* |
| New EU member States | -4.7 | -3.8 | -1.7 | *-1.4* |
| Estonia | -1.8 | 0.4 | 1.1 | *-2.2* |
| Slovenia | -4.7 | -4.4 | -4.5 | *-1.7* |
| Slovakia | -6.6 | -6.3 | -3.2 | *-2.8* |
| Bulgaria | -3.6 | -2.5 | -1.5 | *-1.1* |
| Czech Republic | -4.5 | -3.4 | -1.7 | *-1.4* |
| Latvia | -8.3 | -6.8 | -2 | *-0.4* |
| Lithuania | -8.2 | -5.4 | -3.7 | *-1.2* |
| Hungary | 0.1 | -0.1 | 8.3 | *1.5* |
| Poland | -4.7 | -5.2 | -2.4 | *-0.3* |
| Romania | -7.5 | -5.3 | -3.7 | *-1.1* |
| Croatia | -2.4 | -2.9 | -5.0 | *-5.1* |
| Serbia | -3.7 | -3.4 | -3.4 | *-4.3* |

Source: EC (2012), *European economic forecast - spring 2012*, except for Serbia

Should the current trends continue, and there is no robust fiscal consolidation, the Serbian public debt would significantly exceed the ceiling of 50 percent of GDP as early as in 2012. If the total and primary fiscal deficit are not significantly reduced, public debt could reach 65 percent of GDP in 2014. When the restitution-based liabilities are added, in 2015 the public debt would stand at over 70 percent of GDP.

## 2.2. Costs and Risks of High Public Debt

***The share of public debt in GDP is one of the key indicators of a government fiscal position.*** The movement of the public debt-to-GDP ratio depends on a large number of factors[38], the most important being the amount of the fiscal deficit – the higher the fiscal deficit, the faster the debt-to-GDP ratio will grow. The movement of the ratio of public debt against GDP is further affected by factors acting beside the fiscal deficit, and the most regular and most important in terms of the balance of payments is the issuance of government guarantees. Fiscal deficit and guarantees are under direct control of the government, whereas other factors (GDP growth, interest rates, exchange rate) affecting the change of public debt-to-GDP ratio are under indirect government control only. Though in certain periods the impact of some of these other factors can be significant, it is temporary and sporadic from a long-term point of view.

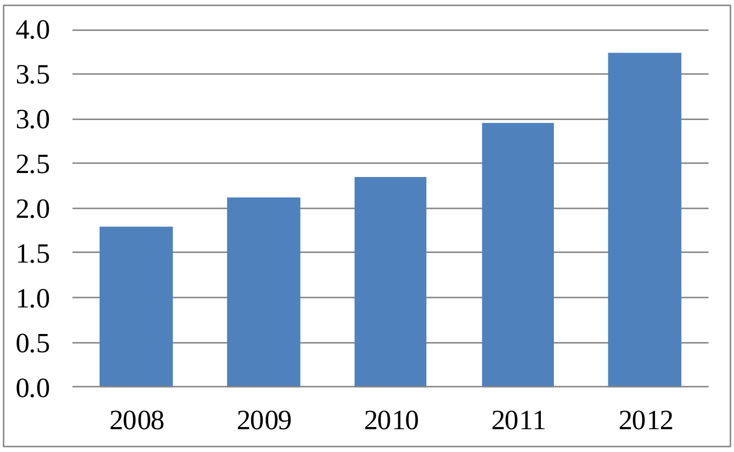
Generally speaking, the higher the ratio of public debt to GDP, the more unfavorable the situation will be for the state because a larger share of tax revenues is set aside for covering interest rates and repaying the principal of public debt. If public debt of a certain state equals 50 percent of GDP and if real interest rates are 5 percent, the state must set aside 2.5 percent of GDP for the interest rates alone. Serbia’s public debt at the beginning of 2012

[38] For more detail, see Arsić et al. (2012)

stood at around 50 percent of GDP, while interest expense was relatively low (around 1.6 percent of GDP), because cheap debts (old foreign currency savings, concession loans from international financial organizations and some bilateral creditors) constitute an important part in the structure of its debt. In the years ahead an increase in interest payments can be anticipated in Serbia, both on account of the increase of public debt and the replacement of cheap loans by more expensive ones.

***A debt increase implies an increase in interest rates on a country's loans.*** If a country with a low credit rating reaches the level of debt which investors assess as risky (e.g. 60 percent of GDP), interest rates on its loans can reach a very high level of 10 percent for example, meaning that even if 70 percent of the debt had been contracted at low fixed interest rates[39], the average real interest rates will exceed 5 percent a year, and the interest payments will increase to around 3 percent of GDP. Such low interest rates, which are higher than the GDP growth rate, lead towards unsustainable increase in the public debt-to-GDP ratio. The change of implicit interest rates[40] shows that the costs of public debt servicing in Serbia have considerably increased during the past four years – presented in Graph 2.3. Implicit interest rates on Serbia's public debt increased by 2/3 in the period 2008–2011, and further increase is expected in the years ahead.

**Graph 2.3 Implicit Interest Rate on Serbian Public Debt (percent)**




Source: Fiscal Council

Public debt crisis in one country does not only affect the public sector and the functions it performs in society (security, judiciary, education, health, social care, infrastructure, etc.), but it also threatens the entire economy of the country. In case of a public debt crisis, interest rates are significantly increased not only for the public sector, but also for the country's private sector, while investments and personal spending decline. In case of a public debt crisis, as a rule, GDP declines by 5–10 percent and unemployment rises. The growth of interest rates, combined with a negative GDP growth rate, leads to an abrupt surge in the public debt-to-GDP ratio. If real interest rates increase on average by 1.5 percentage points and GDP drops by 5 percent, provided other conditions remain unchanged, this leads to

[39] In case of a debt crisis, interest rates on the state's current debts are increased, including loans for debt refinancing and loans for deficit financing, as well as interest rates on loans with variable interest rates, while rates on loans with fixed interest rates remain unchanged.

[40] Implicit interest rates are calculated as a ratio of interest payments in a given year and public debt in that year.

a hike in the public debt-to-GDP ratio from, for instance, 60 percent to around 66 percent of GDP.

However, in such a situation, as a rule, the national currency also depreciates, which results in additional increase in the public debt-to-GDP ratio. If the national currency depreciates by 10 percent in real terms and the foreign currency share in public debt is 80 percent, the public debt-to-GDP ratio will reach approximately 71 percent of GDP. This is why it is paramount for each country to predict the probability of public debt crisis and to take timely measures to mitigate it.

The probability of a debt crisis depends on measurable indicators such as: the public debt-to-GDP ratio, the share of long-term loans in the total debt, currency composition of the debt stock, interest rate composition. The measurable indicators of public debt sustainability include the current level and the trends of the actual and structural fiscal deficit. However, debt crisis probability also depends on the confidence of investors in a country's solvency. Investor confidence partly depends on fundamental economic indicators (i.e. previously mentioned measurable factors), and partly on investors' assessment of whether the government will consistently implement the adopted and announced measures (government credibility), as well as on the history of debt crises of that particular country, etc. It is most unfavorable for a country if factors such as: high public debt-to-GDP ratio, high share of short-term and foreign currency debts, high share of loans with variable interest rates and low investor confidence, occur at the same time.

A country credit rating is a rough indicator of investor confidence, which reflects both measurable economic factors and the perception of investors. Generally, the lower the country credit rating, the higher the probability for the occurrence of a debt crisis if the public debt-to-GDP ratio is low. When it comes to smaller countries, such as Serbia, the IMF's assessments have a strong influence on credit agencies. Due to the considerable impact of confidence and expectations on the behavior of investors, a debt crisis is difficult to predict.

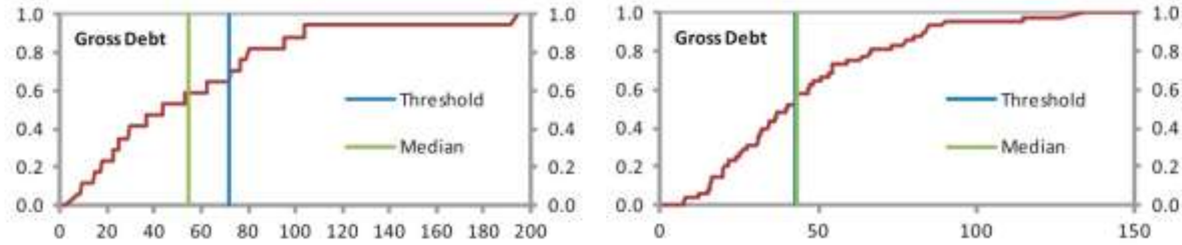
*Limits of the Public Debt-to-GDP Ratio*

Given all of the above mentioned, there is no general limit of public debt sustainability that could be applied to all states – some countries with low expenses finance public debts of over 100 percent of GDP, while others fall into a debt crisis when the public debt reaches 30–40 percent of GDP. There are differences between the level of public debt and the probability of debt crisis in less-developed countries (LDC) and in developed ones. Less-developed countries enter the critical zone, when debt crisis can occur, when their levels of public debt participation in GDP are lower than those in developed countries (43 percent for LDC on average, compared to 72 percent of GDP on average for developed countries).[41] Thus one half of debt crises in less-developed countries, which occurred in the period 1995–2010, came about when the ratio of public debt to GDP was below 50 percent.[42] The reason is that in less-developed countries, with a lower share of the debt in GDP, a crisis of confidence in the country's solvency usually occurs, resulting in a growth of interest rates or the refusal of investors to finance deficit or refinance public debt. This fact should be taken into account when determining the maximum limit of public debt, which in less-developed countries should be set at a lower level than in developed ones.

[41] Baldacci et al. (2011).
[42] Ibid.

**The probability of debt crisis occurrence depending on the share of public debt in GDP for:**

**a) Developed countries** **b) Less-developed countries**




Note: the ***x*** axis shows the share of public debt in GDP, and the ***y*** axis the probability of debt crisis occurrence.
Source: Baldacci et al. (2011)

## 2.3. Proposed Measures for Controlling Public Debt in Serbia

***The statutory public debt limit should not be changed.*** Based on the above, the Fiscal Council states that the limit for the maximum public debt-to-GDP ratio, which stands at 45 percent (including restitution, at around 50 percent of GDP), is well-balanced and that any increase would raise the probability of public debt crisis occurrence. The targeted medium-term level of public debt in Serbia should be lower and stand at around 35–40 percent of GDP (including the debt on account of restitution). A lower targeted level of public debt is supposed to secure room for public debt to remain below the legal minimum in times of crisis, when the country’s debts increase.

Based on all of the above, it may be concluded that a responsible fiscal policy requires that in good times, public debt be kept at the level of at least 10–15 percentage points of GDP below the legal maximum. Sustainable public debt limit for a certain country has a key impact on the possibility to use fiscal stimuli in a time of crisis. If the sustainable public debt limit for a country is lower, there is less room for using fiscal stimuli. Such countries, after only several years of implementing fiscal stimuli, hit the ceiling of public debt sustainability, which in turn has a negative effect on the range of fiscal stimuli.[43] Bearing in mind that Serbia is a small, open economy with a flexible foreign currency exchange rate, its fiscal multipliers and the country’s credit rating are low; there is little room for fiscal stimuli and the risk of debt crisis even with a moderate debt-to-GDP ratio (e.g. a ratio of 50–60 percent of GDP) is relatively high. Therefore, a policy more fitting to Serbia is the one which, by reducing fiscal deficit, will halt the growth of public debt-to-GDP ratio and then secure its decrease – instead of a policy of extensive fiscal stimuli.

***Fiscal rules in Serbia determined that the structural fiscal deficit is 1 percent of GDP, which borders with the latest EU rules.*** However, structural fiscal deficit in Serbia in 2011 stood at 4–4.5 percent of GDP, meaning that it was slightly below the actual fiscal deficit[44]. It may be concluded that the actual fiscal deficit in Serbia is for the major part structural – it was created by a discretionary increase of expenditure on wages, pensions, subsidies and tax cuts – therefore it will be eliminated mostly by saving on wages, pensions and subsidies, and, to a lesser degree, by tax increase.

The fiscal consolidation plan envisages that the actual fiscal deficit in Serbia should reach 1 percent of GDP within three years, whereas within four to five years a fiscal balance would be established. Bearing in mind that the projections assume that GDP growth rate

[43] Ilzetzki, E., E. G. Mendoza and Carlos Vegh (2009).
[44] See Arsić et al. (2012).

would be close to GDP's natural growth rate for Serbia (around 5 percent annually), and taking into account a reduction in foreign deficit, the structural deficit would be close to zero within four or five years. Consistent implementation of the fiscal consolidation programme would provide Serbia with an opportunity to adopt a 0.5 percent of GDP as the legal limit on the maximum level of the structural fiscal deficit, even before it joins the EU.

One of the important measures that could be implemented even during 2012 is to legally regulate a single definition of the scope of public debt, as well as to specify the manner of calculating the public debt-to-GDP ratio. It is important to specify these definitions in order to secure the credibility of data on public debt, as well as their international comparability. Early in 2012 the Fiscal Council published a document which may represent a basis to legally specify the methodology for calculating public debt.[45]

With the aim of timely implementation of measures to prevent a violation of a legal maximum in terms of the public debt-to-GDP ratio, it would be beneficial if a series of successive public debt limits were introduced, as in the case of Slovakia, after whose introduction the government would implement mandatory measures envisaged in advance. The legal introduction of these limits would be achieved during a medium-term, when the public debt-to-GDP ratio is brought down below the stated limits.

Limiting the growth of guarantees is the next important measure of public debt control. In order to slow down and eventually halt the increase of the public debt-to-GDP ratio, strict legal limits on the total amount of guarantees that can be approved during one year must be imposed and the purposes for issuing guarantees must be limited (for more detail see the chapter on guarantees).

*New Fiscal Rules in the EU*

General rules of public debt control, introduced at the EU level in late 2011, are of particular interest for Serbia. They envisage mandatory measures for all member states in case their public debt exceeds the reference value of 60 percent of GDP, as well as sanctions for states which fail to do so.[46] According to new EU rules, when the public debt exceeds 60 percent of GDP, the state must reduce the share of public debt in GDP over the next three years, and if it fails to comply, certain sanctions shall be implemented. Other general rules envisage that a rule on the maximum structural deficit should be introduced into national legislation, as a "public debt brake" of 0.5 percent of GDP. Structural fiscal deficit can be interpreted as a systemic fiscal deficit which reflects a permanent disbalance between taxes and public expenditure, as well as long-term macroeconomic (change in the structure of the economy) and demographic trends (population aging). Alternatively, the structural fiscal deficit can be defined as a real fiscal deficit without the impact of cyclical and one-off factors.[47]

Apart from general rules at the EU level, additional rules have been introduced to some members, which considerably increase the strictness of public debt control. In Slovakia, a series of successive limits for public debt was introduced at levels lower than the Maastricht ones, and concrete measures were defined which the government must implement if any of these limits is crossed. If the Slovak public debt exceeds 50 percent of GDP, the minister of finance must explain the reasons for this and propose a plan to bring the debt back below the

[45] Fiscal Council (2012).

[46] EU (2011), *Treaty on Stability, Coordination, and Governance in Economic and Monetary Union*. Early in 2012 these rules were accepted by all states, except for the United Kingdom and the Czech Republic.

[47] In their paper, Arsić and Pejić (2012) point to potential problems with implementing these rules.

state limit. If the limit of 53 percent of GDP is exceeded, wages in the public sector are to be frozen at the level of the previous year, and a programme of additional measures for reducing public debt-to-GDP ratio must be adopted. If the public debt exceeds 55 percent of GDP, the government must freeze total public spending at the nominal level from the year before, while exceeding the limit of 57 percent of GDP implies that the government must propose a balanced budget for the next year or a surplus budget. If public debt exceeds 60 percent of GDP, the motion of no confidence in the government shall be automatically launched.

Similarly, in Poland's case, the first critical limit for public debt is set at 50 percent of GDP. When public debt exceeds 50 percent of GDP, the government and local organs are under obligation to adopt measures to ensure that the growth of fiscal deficit in relation to public expenditure is halted. When public debt exceeds 55 percent of GDP, the government must propose a balanced budget for the next year, or a surplus budget, whereas if the limit of 60 percent of GDP is crossed, the government must propose a surplus budget, as well as discontinue issuing guarantees for the next year and adopt additional measures aimed at fiscal consolidation. Furthermore, in countries with low credit rating (Bulgaria, Slovenia), the maximum ratio of public debt to GDP is often set at a low level.

The goal of setting pre-emptive limits for public debt at a level lower than the maximum is to create room for public debt increase in a time of economic crisis, and at the same time not to violate the rule on the maximum public debt-to-GDP ratio. Namely, during an economic crisis, fiscal deficit is increased both on account of a drop in revenues and an increase in expenditures. In a crisis, state revenues are automatically decreased by approximately the same percentage as the GDP drop. On the other hand, expenditure is increased, partly automatically (increased assistance to the unemployed and higher social aid), and partly because of the implementation of stimulating anti-recession measures (public investment, bailing out large companies and banks, etc.).

# 3. GOVERNMENT GUARANTEES

**Recent Developments and Issues**

According to the Public Debt Law and Budget System Law, guarantees are part of Serbian public debt. The growth of guarantees contributed to the public debt exceeding the legally stipulated ceiling of 45 percent of GDP at the end of 2011. The guarantees were particularly on the rise over the previous three years. From 2006 to 2008, the growth rate of guarantees stood at mere 0.3 percent of GDP a year, while in the period 2009-2011 this growth rate reached approximately 1.4 percent of GDP a year. In addition, over the previous three years the purpose of issued guarantees has radically changed. Up to 2009, the guarantees were mostly issued for infrastructure projects, while more recently, they are more frequently issued for investment projects of private and public enterprises (FIAT, JAT, RTB Bor, etc.), but also for the economically unjustified purposes such as maintenance of current liquidity, refinancing of existing liabilities, procurement of goods and services.

**Proposed Measures**

1. To limit the maximum allowed amount of the guaranteed debt to 6 percent of GDP in the following four-year period (PE "Roads of Serbia" excluded), followed by the reduction of the allowed amount after 2016. To this end, we propose to legally limit the guarantee growth rate to 2 percent of GDP in the four-year period (2013–2016) and to 0.6 percent of GDP annually.
2. To legally restrict the purposes for which the government guarantees can be issued to major infrastructure projects
3. Consolidated medium-term management of guarantees as part of the public debt, more precisely, a consolidated centralized monitoring, forecasting and control of the contingent government liabilities in the medium term (three or four years).
4. Coordination of public (budget) investments, investments made from guaranteed loans and inclusion of private sector in the construction of infrastructure facilities – public private partnership.

**Expected Effects**

Reducing public debt in 2016 by 2-3 percent of GDP compared to the level of public debt that would be reached if the current upward trend of guarantees persists. The proposed model of issuing government guarantees will contribute to the curbing of public debt in the following four-year period. If the rate of issuance seen in the previous three years continued until 2016, the share of guarantees in GDP (without PE "Roads of Serbia") would reach between 8 percent and 9 percent of GDP. If the proposed measures are implemented, this share would be limited to 6 percent of GDP.

The spiraling public debt experienced in the previous few years was also fuelled by the rapid growth of guarantees issued by the government for the borrowing of other legal entities. According to the legal definition currently in force, these guarantees are included in the public debt stock. This chapter presents the trends of guarantees and possible ways of curbing their growth in the future. The share of guarantees in GDP grew from 3.1 percent in

2008 to 6.8 percent of GDP at the end of 2011. The greatest concern is caused by the fact that that the largest part of the guarantee expansion seen in the previous years is not the result of the developing infrastructure, but the majority of those guarantees were used for the execution of segmented investments projects, and lately even for the liquidity loans, procurement of goods and services and refinancing of old liabilities that the public enterprises were not capable of repaying. In order to cut public debt in the following four-year period, it will be necessary to limit the maximum amount for which the guarantees may be granted, but also to specify their purpose. This could serve as the additional pressure on the government to be firm and determined in the implementation of comprehensive and much-needed reforms of public enterprises - to privatize some, restructure all of them (or almost all of them) and introduce gradual liberalization of the activities performed by public enterprises. In addition, limited scope of further government borrowing will also limit the possibility of implementing the announced large government projects, which will impose a strict selection of projects against priorities and funding capacities.

### 3.1. Issuance of Government Guarantees as Part of Public Debt

***In addition to fiscal deficit, the growth of public debt is caused by many other factors.*** Most of these factors have a one-off and sporadic effect on public debt (restitution-based debt, debts incurred for the capital increase of banks, taking over of private debts – such as Jugoskandik and Dafiment Bank liabilities, etc.), except guarantees, whose impact on the public debt growth is relatively regular as the guarantees are issued almost every year. Public debt based on guarantees is the contingent debt of the government and is incurred when the government takes over the obligation to entirely or partially service a certain debt in the event the debtor is not capable of doing so. The government generally issues a guarantee for the borrowing of entities under its own ownership-based control – public enterprises or other government institutions acting as independent legal entities.[48]

When issuing guarantees, the government is sharing risk with the direct borrower, which reduces the costs of debt servicing compared to the loans that the direct borrower can obtain under market conditions. In some cases, the government guarantee is a condition for granting the loan. Compared to the direct government liabilities, the costs of guaranteed debt are generally somewhat higher, which is why the relevant authorities should always assess the costs and benefits of this type of subsidizing the loan beneficiary relative to other manners of borrowing (borrowing of the loan beneficiary under market conditions or direct borrowing of the government for the purpose of pursuing certain economic policy). Calling on guarantees means that at some point the government takes over, fully or partially, the commitment of repaying the loan and it is usually the result of the inability of the guaranteed loan beneficiary to service debt, which is why the contingent liability becomes a direct liability of the government.

***There are two main approaches to the inclusion of guarantees in the public debt stock.*** The most common approach used in practice (Maastricht criteria and methodology) implies that the guarantees become part of public debt only after being called and the government begins the resulting payments. The other, more conservative approach implies that the entire amount of issued guarantees is included in the public debt stock immediately after the debtor draws a tranche of the loan, automatically increasing the debt stock.

[48] There are exceptions here, as well, which is why the government sometimes issues guarantees for the debts of private companies, as was the case with the guarantees issued for the borrowing of the Italian FIAT.

Both approaches have certain advantages and disadvantages. The advantage of the first approach is that it does not lead to the unrealistic increase of public debt when the guarantees are issued for the benefit of entities that regularly service their debt. However, this approach can lead to a sudden and sharp increase of public debt if a large amount of called guarantees is included in the public debt stock at once. The probability of calling on guarantees increases when economic crises escalate, and this is when guarantees can pose an extremely serious threat to public finances (example of Montenegro issuing guarantees for the Aluminum Plant). In addition, this methodology can enable a very dangerous, temporary postponement of recording actual liabilities of the government in cases when it is quite certain, even at the moment of contracting a loan, that the debt burden will be borne by the government. Namely, if a loan has a somewhat longer grace period, according to Maastricht, that loan would not be included in the public debt until the calling of the guarantee, i.e. the first installment of repayment, which can occur even several years after the loan is withdrawn.

The strong point of the second approach (inclusion of all issued guarantees in public debt) is that this approach prevents the possibility of a sudden and significant increase of public debt on the basis of the calling on guarantees. Its drawback, however, is the fact that the public debt presented in this way is larger than the actual one - for the amount of those guaranteed loans regularly serviced by the debtors, without imposing a burden on the government. Such increase of public debt has an adverse effect on the country's credit rating and consequently raises the costs of servicing public debt.

***In addition to these two approaches, there is also a third, middle approach which is conceptually superior, but leaves some room for manipulation.*** In its working paper[49] Fiscal Council proposed that the guarantees are included or excluded from public debt in line with the estimated risk of them being called. This would minimize the possibility of future shocks while at the same time it would improve the international comparison of the official data on Serbian public debt and develop the medium term projections of public debt.

There are two different legal definitions of public debt in Serbia – in the Public Debt Law and Budget System Law.[50] According to both definitions, the contingent liabilities of the Republic stemming from the issued guarantees are entirely included in the public debt. Until there is a change in the coverage and manner of calculating Serbian public debt, we will use the public debt definition contained in the Budget System Law, which stipulates that public debt includes all guarantees.

Issuance of government guarantees in Serbia is performed in several phases:

1. Signing the loan agreement between the borrower (loan beneficiary) and the creditor (bank or other financial institution), conditioned on the guarantee to be issued by the Republic;
2. Ratification of the guarantee agreement by the government and the creditor, which is also subject to Parliamentary procedure, and
3. Guarantee coming into effect and withdrawal of the guaranteed debt proceeds by the beneficiary, which is when the guarantee is included in the public debt portfolio.

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[49] In the "Proposal for the Adjustement of the Serbian Public Debt Coverage and Measurement Methodology“, Fiscal Council conducted a research proposing a public debt coverage which is better aligned with the international standards, considering that in Serbia there are strong risks that the government will eventually have to repay the guaranteed debt.

[50] For the implementation of fiscal rules regarding the public debt and deficit, pertaining to the general government level, the definition of the general government applies, i.e. measuring public debt in line with the Budget System Law.

The proceeds can be withdrawn in full amount or gradually over several years, which is most commonly the case: on average, during the year when the guarantee is issued about 50 percent of the contracted amount is withdrawn, which is included in the public debt. For example, in 2010 the amount of withdrawn proceeds from the loans granted that year equaled 1.02 percent of GDP compared to 2.11 percent of GDP of the contracted amount, while in 2011 the withdrawn amount stood at 1.44 percent compared to 2.53 percent of the contracted loans amount. The rest of the contracted amount is withdrawn in subsequent tranches (although we have also noticed that some contracted loans are not withdrawn at all even years after the guarantee is issued - which might be an indication that certain projects are being abandoned). This is why the projections of trends of the guaranteed debt are not always accurate, and the situation is further aggravated by the possibility that in the following four years some old guarantees might be called. At the end of December 2011, the total stock of issued but uncalled guarantees stood at 2 percent of GDP, which is why the guaranteed debt will probably continue to grow, even if the issuance of new guarantees was terminated.

### 3.2. Analysis of the Current Stock of Guarantees

***At the end of 2011, Serbian public debt related to issued guarantees equaled 6.8 percent of GDP.*** We have discovered a significant annual increase of the guaranteed debt over the past several years (Table 3.1). Due to the increased volume of issuance, the growth rate of guarantees rose from the average level of 0.3 percent of GDP a year, which was recorded from 2006 to 2008, to roughly 1.4 percent of GDP in the period 2009-2011. This growth seen in the previous three years resulted in the increased share of the guaranteed debt in GDP by 3.7 percentage points (from 3.1 percent of GDP to 6.8 percent of GDP - Table 3.1).

**Table 3.1 Stock of Guaranteed Debt and Annual Growth Rate of Guarantees in Serbia 2006–2011 (percent of GDP)**

| | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|---|
| Guaranteed debt -stock | 3.10 | 2.94 | 3.09 | 4.92 | 6.27 | 6.83 |
| Annual growth rate of guaranteed debt | 0.43 | 0.27 | 0.27 | 1.64 | 1.17 | 1.29 |
| *Guaranteed debt without guarantees for PE “Roads of Serbia” and municipalities* | 1.22 | 1.19 | 1.32 | 2.07 | 3.22 | 4.22 |
| *Annual growth rate of guaranteed debt without guarantees for PE “Roads of Serbia” and municipalities* | 0.14 | 0.14 | 0.18 | 0.68 | 1.07 | 1.37 |

Source: Fiscal Council, based on the Ministry of Finance data

In Table 3.1, in the last two rows, from the total guarantees we excluded those that pertain to the PE "Roads of Serbia" and local governments. Namely, according to the definition in force, PE "Roads of Serbia" and local government belong to the general government, which means that all projects funded from their loans, and which are guaranteed by the Republic, are included in the consolidated balance (deficit included) of the general government. In order to avoid double counting[51], in the following text we will perform the quantity analysis of only those guarantees that do not include PE "Roads of Serbia" and local government.

We also made a detailed analysis of the guarantees issued in the previous years according to their purpose. Namely, the purpose of loans backed by the guarantees varies significantly. We divided all the guarantees into three purpose-related groups:

1) First group consists of large infrastructure projects (for the construction of roads, railways, energy infrastructure, etc.) whose execution is necessary and of general interest for the country. Therefore, we find the issuance of these guarantees, with certain limitations, justified. When it comes to the limitations, we believe that the government should not *a priori* endorse all proposed infrastructure projects without performing a detailed analysis of all its costs and benefits. Given that every new borrowing, even for the necessary infrastructure, increases the public debt stock, the authorities should, for these guarantees as well, make a list of national priorities and a selection of the proposed projects.
2) The second group of guarantees consists of the guarantees issued for the investments of the private and public enterprises (JAT, FIAT, RTB Bor, etc.). The question that can be raised here is why these projects, if they are indeed cost-effective, are not funded under market conditions. The additional problem lies in the fact that the government guarantees for the repayment of loans can by definition lead to the moral hazard, more precisely, it can cause the situation where the enterprises knowing that the government has assumed the potential obligation to repay the loan on their behalf more easily opt for risky and irresponsible investment projects.
3) Third group of guarantees, appearing in the past several years, includes the loans for various purposes where we can hardly recognize a clear national interest and the supporting strategy. This is the issuance of guarantees for the liquidity loans, purchase of goods and service, even refinancing of the existing liabilities. This type of guarantees primarily indicates poor management of public enterprises and is essentially an indirect government subsidy to those enterprises. Therefore, we believe there is a great probability that the government will repay these loans, which is why this type of guarantees should be entirely eliminated in the future.

***Infrastructure projects are not the reason behind the growth of guarantees.*** When analyzing the purpose of the guarantees issued, we can see from the breakdown made in Table 3.1 (PE “Roads of Serbia” and municipalities excluded) that the rapid growth of the guaranteed loans over the previous three years was mainly not a consequence of large infrastructure projects. More precisely, Table 3.1 shows that in the growth of the guaranteed debt share in GDP of 3.7 percentage points that took place over 2008-2011, as much as 3 percent of GDP came outside the road construction. Additional analysis proved that there was no increase in the guaranteed loans for investments in the energy system, which could also be categorized as significant infrastructure projects.

In fact, the growth rate of guarantees recorded in the previous three years was mostly fuelled by the investment and other loans taken by PE Srbijagas, PE JAT Airways, FIAT,

[51] The purpose of this chapter is to present possible guidelines for the control of the growth of that part of public debt which is not connected to the funding of deficit овог. Since PE “Roads of Serbia“ and local government form part of the general government, loans taken by them can be treated as borrowing for financing deficit. This is why we will analyze in more detail only those guarantees which are issued to the entities not belonging to the general government.

RTB Bor and the Serbian Construction Directorate. Similar structure of beneficiaries is seen in 2012 when sizeable guarantees are issued for the borrowing of Galenika (pharmaceutical company) and PE JAT Airways, as well as for the construction of the housing blocks in the location of the military facility Stepa Stepanovic in Belgrade. The trends envisaged for the near future are also quite indicative – the 2012 budget anticipates large increase of the guaranteed loans for the refinancing of the existing liabilities, maintenance of the current liquidity, purchase of goods and services, etc. This is why we find that the structure of growth and the trends of the guaranteed loans are unfavorable since there is a growing issuance of the guarantees that are not economically rational (as explained in the above division of guarantees into three purpose-related groups).

***It is important to put a ceiling on the guarantees.*** In view of the above, we have come to the conclusion that the key factor for the future control of the guaranteed debt growth will be the limitation of the total amount of guarantees, as well as strict legal definition of the purposes for which guarantees may be issued. Reduction of guarantees is closely connected to the wider reforms of public enterprises and other entities under the government control. An important measure that must be implemented for the purpose of reducing the level of issuing guarantees is to improve the efficiency of public enterprises through their restructuring, which would enable them to borrow under market conditions without being dependent on the government guarantees. In some cases it is necessary to increase the prices of services (gas, electricity, heating) up to the level of justified costs. Finally, it is vital to carry out an effective liberalization of the electricity production in order to enable private investors, independent of EPS, to build thermal and hydro-thermal plants. This would reduce the need for excessive borrowing of EPS, but also for the issuance of guarantees for these purposes.[52]

In addition to restructuring, we believe it will be necessary to re-examine the size and structure of the government ownership in the enterprises that face strong competition regarding their core activity (production of medicines, air transport, telecommunications, etc.) According to the EBRD data, Serbia has the largest share of the state-owned sector in the economy, compared to all other transitional countries, which is why the privatization of public enterprises operating in the competitive areas one of the ways to reduce the number of potential beneficiaries of government guarantees.

Finally, it is necessary to re-examine certain sectoral government projects and economic policies that are currently being pursued or announced, and which require the issuance of government guarantees. Namely, if we sum all the amounts needed for every envisaged project (railways, road infrastructure, energy, housing, etc.), this amount would greatly exceed the possibilities allowed by the high and unsustainable level of public debt. This is why it is important to make a rigorous selection of priorities and to give up or postpone low priority projects.

### 3.3. Proposed Sustainable Model of Issuing Government Guarantees

***The unsustainable upward trend of public debt proves that it is necessary to introduce a strict control of the issuance of government guarantees in the period 2013-2016.*** On the other hand, at this moment it is impossible to accurately forecast the future growth of public debt based on the government contingent liabilities. Future volume of the guaranteed debt will primarily depend on the performance and actual needs of a number of individual beneficiaries or potential beneficiaries of guaranteed loans, which requires a much

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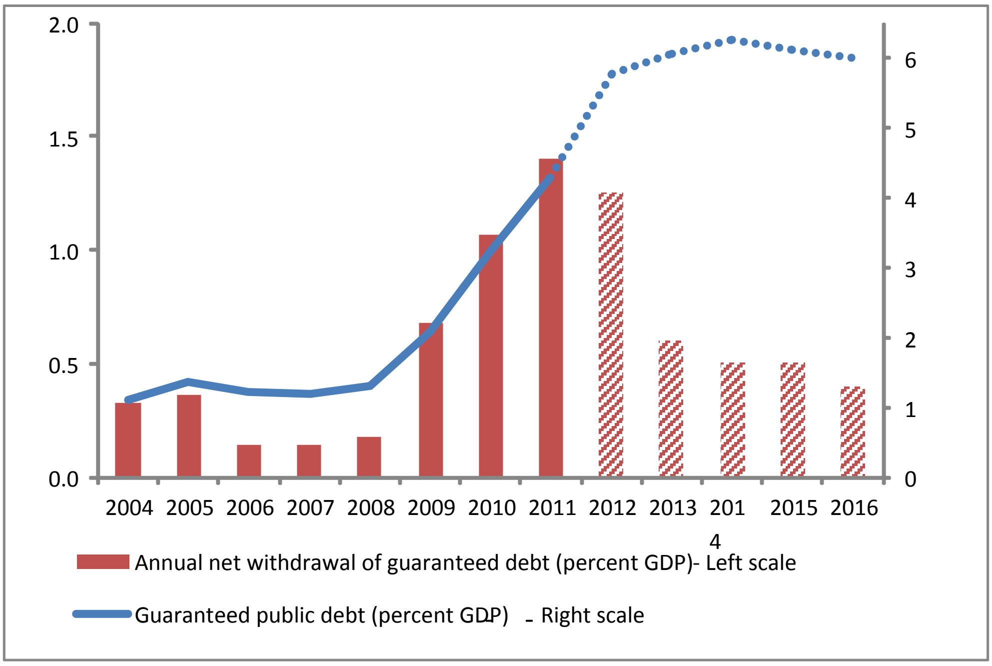
[52] See Chapter 8.

more comprehensive analysis than the one provided here. On top of that, one must bear in mind that the performance and actual needs of individual enterprises do not only define the level of potential guarantees, but also affect the dynamics of withdrawal of the remaining granted but unused funds. Still, it is necessary to introduce certain limitations and principles in order to put the growth of contingent liabilities under strict control.

1. *Limiting the maximum allowed amount of guaranteed debt in the following four-year period, followed by its reduction after 2016.* The need to curb public debt and then to reduce its volume below the statutory limit of 45 percent of GDP in the next four-year period also imposes the need to limit the maximum growth rate of the guaranteed debt. A preliminary analysis shows that this objective requires the limitation of the maximum share of guaranteed debt in GDP to the level of approximately 6 percent (PE "Roads of Serbia" and local government excluded), which would be reached in 2015 or 2016, and then the aim would be its further reduction. Graph 3.1 illustrates possible trends of guaranteed debt in the next four years. The schedule of new guarantees broken down by years shown in Graph 3.1 for the period 2013-2016 is arbitrary since we do not have reliable data on the future withdrawal of granted guaranteed loans, nor on the needs for new guarantees. In practical terms, it is most important to limit the maximum amount of the total new guarantees by 2016, while their distribution by individual beneficiaries and timeframe would be determined according to the objectively evaluated priorities. The concrete proposal for the legal limitation on the issuance of guarantees is to stipulate that the share of the growth rate in GDP in the following four-year period (from 2013 to 2016) must not exceed 2 percent of GDP. In addition, the lawmakers should introduce the annual limit of 0.6 percent of GDP in order to prevent the excessive issuance of guarantees over the first year, which would lead to the violation of the growth rate limit in the four-year period.

**Graph 3.1 Annual Value of Called Guarantees and Stock of Total Guaranteed Debt*, 2004–2011, with Illustrative Assessments up to 2016**




* Without guarantees for PE "Roads of Serbia" and municipalities
Source: Fiscal Council, based on the Ministry of Finance data

2. *Legal restriction of the purposes for which government guarantees can be issued.* We believe that issuing government guarantees for the borrowing of third parties is only completely justified when the loan is taken for significant infrastructure projects – with the prior analysis, prioritization and selection of the projects proposed. Government guarantees for investment loans of private and public enterprises should be terminated, with certain exceptions – when the clear national interest of such a loan is evident and the guaranteed amount is in line with the aforementioned limitation of the total amount of possible guarantees. Finally, guarantees for the loans taken for the liquidity, refinancing, and purchase of goods and services are in fact a government's subsidy to a public enterprise and point out to the inefficient management of state-owned property. Therefore, we strongly believe that this type of guarantees should be completely eliminated, and that the government should use other policies to improve the operation of the enterprises under its control (see chapter on the restructuring of public enterprises). Restriction of the scope and structure of issued guarantees is one of the key measures for curbing, and then even reducing the debt-to-GDP ratio. Limitation on the guarantee growth rate will also impose an indirect pressure on the government to be more determined in implementing comprehensive reforms in the public enterprises sector, such as privatization of some enterprises, restructuring of almost all of them and liberalization of the activities performed by public enterprises, etc.
3. *Consolidated medium-term management of guaranteed debt*. It is necessary to improve analytical and operational capacities for the management of contingent government liabilities. This also implies a centralized management, forecast and control of these trends in the medium term (three or four years). Based on the individual analysis of the beneficiaries and potential beneficiaries of the guaranteed loans, the authorities need to define and quantify the objective needs and social benefits arising from each government guarantee. In addition to the precise and consolidated plan of the future repayment of the guaranteed debt and withdrawal of unused tranches of granted loans, it is also necessary to assess the probability of individual guarantees being called on, as well as the likelihood of issuing new guarantees for the refinancing of the existing debts. Limitation on the total amount of guarantees for a four-year period will most probably lead to the stricter selection of the projects, as there will be more requests for guarantees than the government can provide. This is why we reiterate the need for professional analysis and comparison of social benefits of several different projects/policies in order for the limited resources to be appropriately planned and allocated.
4. *Coordination of public investments and investments made from guaranteed loans.* If the previously described conditions are met – 1) limitation on the total amount of guarantees in the medium term (and annually); 2) restriction of issuance of guarantees only on major infrastructure projects; and 3) centralized and professional evaluation and prioritization of the projects in need of government guarantees – the government will be able to optimize all of its needs for infrastructure construction in line with the total capacities (budget allocations for public investments and guarantees). Efficient management, coordination and clear strategic framework for major infrastructure projects would result in the objective review of the possibility to include some other forms of funding infrastructure projects (liberalization of electricity production, concessions, public-private partnerships, etc.). Given that the needs for infrastructure investments are great and bearing in mind all the above limitations for government interventions, it is also necessary to consider the option of including private sector in

the construction of infrastructure facilities. From the point of view of overall investments, liberalization of electricity production is extremely important as this would prevent excessive borrowing of EPS and the government. EPS used to repay guaranteed debts in the past, but if it decided to take several large loans for the construction of thermal and hydro-thermal plants, this would increase the likelihood of the government being obliged to repay part of those debts. This is why, in case of EPS it is justified to issue government guarantees for the loans used to revitalize the existing power plants, but the guarantees for the construction of new facilities can be very risky from the aspect of the public debt sustainability.

We wish to stress that no potential modification of the public debt definition (exclusion of guarantees) should be used for the increase of their stock. Therefore, lawmakers should be exceptionally careful if changing the relevant legal framework. Even if only a portion of guarantees was excluded from the public debt stock (proposal of the Fiscal Council), this must not lead to the relaxation of the rules applying to the rest of the guarantees that remain part of the public debt.

## 4. FISCAL CONSOLIDATION AND SOCIAL POLICY

**Recent Developments and Issues**

Since the start of the economic crisis, the living standard of the population at large deteriorated notably: the unemployment rate reached close to 25 percent, the poverty rate exceeded 10 percent, and a relatively large portion of the population falls slightly below the poverty line. An increase in taxes and administered prices will result in a further, though temporary, worsening of the living standards. An inefficient government sector and the presence of corruption play down on people's willingness to accept the burden of fiscal consolidation.

**Proposed Measures**

1. Material forms of social assistance to households and minimum pensions would be exempted from the freeze, protecting the poorest segments of the population from tax increase and rises in administered prices.
2. At the level of the Republic, a fund for one-off assistance to vulnerable population categories would be formed.
3. Local governments would take a more active role in social protection.
4. Decisive and indiscriminate fight against corruption.
5. Even distribution of the burden of fiscal consolidation.

**Expected Effects**

The program of fiscal consolidation would temporarily affect the population's living standards in an organized way, which is necessary in order to avert a debt crisis and an even sharper fall in living standards. Above-the-average burden of consolidation would be borne by public sector employees, which is justified from an economic point of view as public sector wages are higher than in the private sector, and the risk of redundancy is smaller. The standard of the poorest citizens would be protected through an indexation of their income to price growth. Suppression of corruption, improved quality of government services and the creation of conditions for the economy to return to a long-term sustainable growth path would increase people's readiness to accept temporary savings measures.

An increase in taxes and administered prices, together with a freeze on public sector wages and pensions, will temporarily lower the population's living standards. Organized lowering of household income is necessary in order to avert a debt crisis that would trigger a still sharper fall in GDP, employment and, consequently, standards of living. Depending on the scale of increase of the VAT rate and assuming a 10 percent rise in electricity and utility prices, headline prices could see a one-off increase of 2.2 – 4.3 percent. The task of the social policy is to mitigate the impact of such price increases on the living standard of the poorest segments of population. The poorest citizens could be protected from the effects of the rise in prices through indexation of material forms of social benefit (family material assistance and child benefit) and minimum pensions to consumer price growth. In addition, it would be desirable to set up a fund for one-off assistance to the poor at the level of the Republic, while local governments should take a more active part in social protection programs. This would help protect real income of the poorest population segments against the increase in taxes and administered prices. Social assistance to the poorest segments of population, in parallel to elimination of non-productive spending and an increase in the quality of public sector services, is significant for creating a broad social consensus for implementing fiscal consolidation.

### 4.1. Developments of Selected Indicators of Living Standards

***An improvement in citizens' standard of living over the past decade was discontinued on account of mounting problems in the domestic economy and the outbreak of the global economic crisis in 2008.*** Until 2008, the level of real wages increased dynamically, unemployment declined, and the number of people living below the poverty line subsided.[53] Between 2008–2011, reverse trends ensued: unemployment rate and the number of citizens living below the poverty line picked up again shown in Table 4.1. At the end of 2011, the unemployment rate reached 24.4 percent, while the number of the poor is estimated to have risen to around 11 percent, primarily on account of a surge in unemployment. Another problem is that a relatively large number of citizens – Serbia's middle class – live slightly above the poverty line and that the average living standard is low. According to statistical data, real wages in the period of crisis continued to rise moderately, which is unexpected given that public sector wages declined notably in real terms in the 2009-2010 period, while private sector employment subsided. The recorded growth in real wages could result from the fact that employees with the lowest wages were most frequently laid off during this period. In addition, divergent movements in real wages and employment point to structural problems in the labor market (low flexibility of certain segments, etc.)

**Table 4.1 Development of Selected Indicators of Living Standards in Serbia**

| | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|---|---|
| Real wages, 2005 = 100 | 100.0 | 111.4 | 133.1 | 138.3 | 138.6 | 139.6 | 139.8 |
| Unemployment rate, percent | 21.8 | 21.6 | 18.8 | 14.4 | 16.9 | 20.0 | 23.6 |
| Poverty rate | | 8.8 | 8.3 | 6.1 | 6.9 | 9.2 | 11.0* |

* Estimate
Source: Statistical Office of the Republic of Serbia, Fiscal Council

***A body of research indicates that economic inequalities in Serbia are moderate and broadly similar as in other Central European countries which are characterized by low economic inequality.*** According to World Bank data, the Gini coefficient[54], as the most common measure of economic inequality, came at 0.278 in Serbia in 2009 compared to 0.432 in Macedonia. According to Eurostat data[55] for the same year, the average Gini coefficient for the 12 new EU members was 0.303, compared to 0.332 in Bulgaria, 0.333 in Romania and 0.315 in Croatia. This indicates that Serbia's key problem is not so much the economic

[53] As the methodology for calculating average wages has been repeatedly changed since 2001, statistical data are not fully comparable – therefore, real wages are unlikely to have increased as much by 2008 as statistics seem to indicate. Unemployment figures should also be taken with some reservations, as it is unlikely that unemployment fell as much in the 2005-2008 period as statistics seem to indicate. Despite such methodological incomparability and errors of measurement, statistics are still reflective of an underlying trend: improvement of standard until 2008 and its subsequent deterioration.

[54] The Gini coefficient ranges from 0 to 1. The lower the coefficient, the lower the inequality. The lowest value of the Gini coefficient is recorded by Scandinavian countries where it comes at around 0.25, while many countires of Africa, and Middle and South America have coefficients of over 0.5.

[55] For statistics on the Gini coefficient, follow the links: www.worldbank.org and www.eurostat.eu.

inequality but rather low average living standards of its population. This leaves limited scope for improving the standards of citizens living in poverty through a redistribution of income. Given the bad economic standing not only of the poor but of the middle class as well, it is important to understand that acceleration of economic growth, and not income redistribution, is a key condition for improving living standards as it normally results in increased productive employment in the private sector. One of the preconditions for speeding up economic growth is tight fiscal consolidation that will help prevent a public debt crisis and preserve macroeconomic stability. However, in different ways (through an increase in taxes, freezing of wages and pensions, increase in administered prices, redundancies) fiscal consolidation will induce a temporary deterioration of living standards. It is therefore necessary to provide a prior estimate of the effects of fiscal consolidation on citizens' living standards and to develop measures for state aid to the poorest segments of population. It is also very important to foster the middle class's readiness to accept the necessary savings measures by eliminating non-productive costs in the public sector, reducing corruption and enhancing the quality of public services.

### 4.2. Estimated Effects of Fiscal Consolidation on Living Standards

***VAT increase pushes up prices and affects living standards.*** Although from the fiscal and economic point of view the proposed VAT increase is a valid fiscal consolidation measure aimed at preventing a public debt crisis, over the short run it will lead to a one-off price increase and a temporary fall in the living standards of the majority of population. It is a short-term economic price that has to be paid in order to stabilize public finances and avert serious potential problems that would be produced by a debt crisis. Freezing of public sector wages and pensions, coupled with a rise in inflation, will mean that real public sector wages will decrease more than wages in the private sector. This is justifiable as public sector wages have been higher than those earned in the private sector for a long period of time. In addition, the Government will also have to take other measures that will lead to a certain reduction of real income, such as raising the prices of electricity and heating. These price increases are necessary in order to downsize public enterprises' losses and the amount of subsidies these enterprises receive from the state.

***The effect of the VAT increase on prices is uncertain.*** As the VAT increase will affect living standards and corporate sector profitability through a one-off price increase, it is necessary to evaluate by how much prices would go up if VAT is raised. Estimates of the effects of a VAT increase on prices are frequently based on the assumption that the full effect of the VAT increase will shift to prices of final products and, consequently, to consumers. Such assumption is probably justified in the middle or long run, when the producers and merchants shift the full burden of the VAT increase to consumers. However, over the short run, this assumption is frequently flawed, as producers and merchants are not able to shift the full effect of the tax increase to consumers. This is particularly the case when VAT is raised at times of crisis when demand is low, as well as in cases of demand characterized by high price elasticity. This evaluation, therefore, comprises two stages. In the first stage, the maximum theoretically possible impact on prices is evaluated, while the second stage involves the evaluation of the expected (lower) effect on prices based on relevant research including a number of countries.

If the standard VAT rate should increase from 18 percent to 20 percent, and the reduced VAT rate from 8 percent to 10 percent, the average weighted VAT rate would increase from 14 percent to 16 percent, which means that the costs of the tax would increase by around 14 percent. If the full effect of the VAT increase shifts to consumer prices, the

VAT increase will directly result in a 1.51 percent increase in prices. This calculation refers to products taxed directly by VAT. If products which are taxed indirectly by VAT are included (natural consumption, health services and education services)[56], the current average VAT rate would be 12.9 percent, while both VAT rates (standard and reduced) would, after an increase by 2 percentage points, come to 14.8 percent. In this case, the direct effect of the VAT increase on price growth would be somewhat lower and equal 1.47 percent.

If the full effect of the VAT increase spills over to final prices, the full cost of such increase would be borne by final consumers – private individuals. Assuming no change in their nominal income and a roughly 1.5 percent increase in prices, the real purchasing power of household income (wages, pensions, social assistance, income from capital, remittances, etc.) would decline by around 1.5 percent (1/1,015≈0.985), entailing purchasing power loss of RSD 760 per month for an average household.

***However, as international empirical research implies, the VAT increase does not fully shift to final prices, i.e. consumers, over the short run.*** This means that a part of the burden entailed by the VAT increase is borne by producers and merchants. Their profits and margins contract, but a part of the burden may also be shifted to the production and trade staff. It is relatively complicated to come up with an estimate of an isolated effect of a VAT increase on prices, as simultaneously with the introduction of VAT in a country, a large number of other changes occur which also affect prices (e.g. it is possible that the VAT hike is accompanied by depreciation or appreciation of the domestic currency, wages and pensions go up or down, energy prices increase or decrease, monetary policy is tightened or loosened).

***Prevailing estimates indicate that a 1 percentage point VAT rise has an isolated effect of 0.4-0.8 percentage points on increase in prices.***[57] In particular, small-scale shift of the VAT to final prices is typical for periods of economic crisis when aggregate demand is low and price elasticity of demand high. However, this shift is more pronounced in smaller economies, especially those characterized by relatively low level of competition in the domestic market, as is the case in Serbia. It can therefore be assumed that over the short run Serbia will see a shift closer to the upper bound of the above interval or around 0.8 percentage points, which indicates that a 2 percentage points increase in both VAT rates would have a 1.2 percent (= 1.51 percent * 0.8) impact on inflation over the short run.

In addition to the above basic scenario of the VAT increase, the inflationary impact of several other scenarios has also been simulated, assuming an 80 percent spill over of costs of tax increase to prices:

- If both VAT rates are raised by 4 percentage points, the impact on inflation would be around 2.4 percent.
- Raising the standard VAT rate by 4 percentage points and the reduced VAT rate by 2 percentage points would lead to a roughly 2 percent increase in inflation.
- Raising the standard rate by 4 percentage points and the reduced VAT rate by 2 percentage points, with transfer of one half of products from the reduced to the standard rate, would produce an inflation of 3.3 percent.

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[56] As zero tax rate is not applied in Serbia's domestic trade, a certain VAT percentage is contained in natural consumption (around 5 percent) and services (education health, government services) that are exempted from VAT in the final stage (around 10 percent). VAT is indirectly present in natural consumption, through the purchase of inputs (fuel, manure, fodder, plant protection chemicals, etc.) that are VAT taxed. The same goes for services that are exempted from VAT in the final stage (education, health, administrative services), but contain VAT in the inputs used for the provision of the above services (medications, utility services, electricity, equipment, office supplies, etc.).

[57] Viren Matti (2009), *Does the value-added tax shift to consumption prices?* Labour Institute for Economic Research, Discussion Papers 250.

In addition to a VAT increase, it is almost certain that electricity and heating prices will go up in order for their stable supply to be maintained. If prices of electricity and heating go up by 10 percent, this would produce inflation of around 1 percent. Hence, total price increase on account of the rise in the VAT and administered prices would range from 2 to 4.3 per cent, depending on the VAT rate and assuming an 80 percent spill over of VAT costs to prices. The decision to keep these prices unchanged would threaten the financing of network maintenance, building of new capacities and regular supply of electricity and gas. Moreover, low prices of electricity, gas and heating send wrong signals to the economy (capacities are constructed that rely heavily on the above resources), while the largest absolute, and sometimes even relative, benefits from these subsidies are often reserved for wealthy individuals.

In 2011, average monthly household consumption came at RSD 47.6 thousand. A 2 percent price increase is equivalent to the loss of around RSD 900 per month, while a price increase of up to 4.3 percent is equivalent to a loss of around RSD 2000.

***From the social policy standpoint, it is relevant how much the VAT increase will affect prices for households that belong to different social groups classified according to level of consumption.*** As VAT is a tax on consumption, and non on total income earned, in methodological terms it is more justified to analyze the impact of the VAT increase on household spending than on income.[58] The impact of the VAT hike on inflation by consumption groups will be analyzed assuming a 2 percentage point increase in the standard and the reduced VAT rate.

Differences in price growth by consumption groups may be a consequence of the fact that different groups have different spending structures subject to different VAT rates. These differences could potentially be significant as an increase in both VAT rates by 2 percentage points raises the standard tax rate by 11.5 percent (from 18 percent to 20 percent) and the reduced tax by 25 percent (from 8 percent to 10 percent). Raising the VAT rate will also have an indirect effect on the increase in the VAT contained in natural consumption and services that are not taxed in the final stage, but this effect is likely to be weaker.

**Table 4.2 Structure of Household Consumption Expenditure by Decile and VAT Rate, 2009**
(in percent, total decile consumption = 100)

| Decile | Standard VAT rate | Reduced VAT rate | Exempted from VAT | Natural consumption expenditure | Mean effective VAT rate |
|---|---|---|---|---|---|
| 1 | 43.5 | 42.5 | 0.6 | 13.4 | 12.0 |
| 2 | 48.6 | 38.5 | 1.0 | 11.8 | 12.5 |
| 3 | 48.2 | 39.6 | 1.0 | 11.2 | 12.5 |
| 4 | 49.3 | 41.6 | 1.4 | 7.8 | 12.7 |
| 5 | 49.1 | 41.6 | 1.4 | 7.9 | 12.7 |
| 6 | 51.5 | 40.4 | 1.9 | 6.2 | 13.0 |
| 7 | 51.7 | 40.5 | 2.6 | 5.2 | 13.1 |
| 8 | 52.8 | 38.8 | 3.1 | 5.3 | 13.2 |
| 9 | 54.7 | 38.6 | 3.0 | 3.7 | 13.4 |
| 10 | 59.5 | 32.5 | 5.4 | 2.5 | 14.0 |

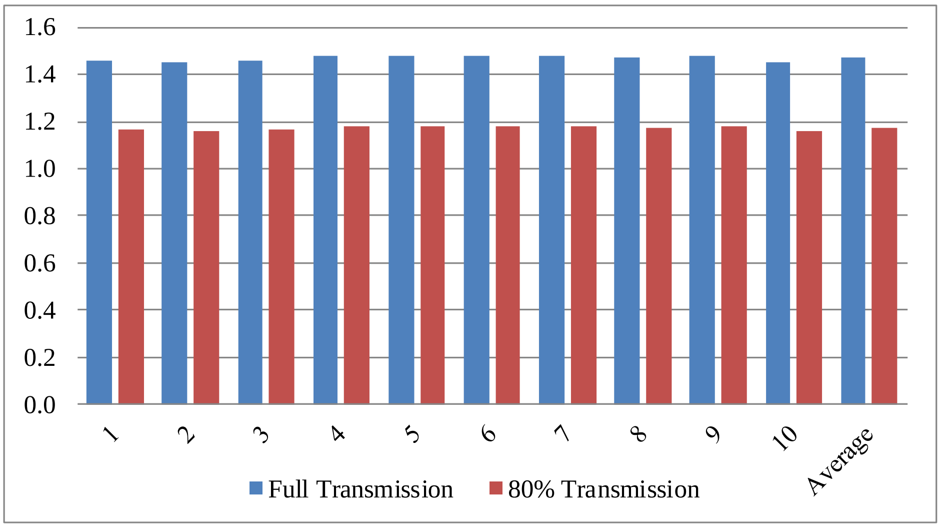
Source: Arsić and Altiparmakov (2011)

[58] Creedy (1998).

The structure of household consumption expenditure of the two poorest population deciles differs from the average by a relatively small ratio of products taxable at the standard VAT rate and by products exempted from VAT at the last stage, while the ratio of natural consumption expenditure is considerably higher than the average. The ratio of products taxable at the rate of 8 percent may be expected to increase in the structure of consumption expenditure, in which case the prices of products that they consume will rise above average. However, this is not the case as the average ratio of products taxable at a tax rate lower than 8 percent in two poorest deciles (40.5 percent) is slightly higher than the average ratio of consumption expenditure at the lower VAT rate in the whole population (39.5 percent). This result and a low ratio of VAT-exempted products in the structure of consumption expenditure with poor population indicates a rather poor targeting of products with a more favorable VAT treatment[59] (see the chapter on tax reforms). The lower rate is used equally by both the poorest and the more well-off population strata, and it should be only the poor, as this is a welfare rate.

***Increasing VAT will not affect the poor beyond the average.*** Given that the rise in spending per deciles is accompanied by a rise in spending taxable at the standard tax rate (18 percent) and services and a fall of the ration of natural consumption, the average effective VAT rate for all consumer groups is even slightly progressive – shown in Table 4.2. Based on the foregoing, we could draw a conclusion that the *increase in the standard and reduced VAT rate for 2 percentage points will not affect the poorest population strata beyond the average.*

**Graph 4.1 Increase in Expenditure Due To Increase in VAT, by Deciles (in percent)**




(Legend: Blue bars – Full transfer; Red bars – Transfer 80 percent; Diagonally oriented text – Average)
Source: Arsić and Altiparmakov (2011), Fiscal Council

Even though the VAT increase by 2 percentage points would result in an increase in spending in all population strata by approximately the same percentage point of about 1.2 percent, the ability of various population strata of bearing this additional expenditure shock varies from one to the next. Population strata that are already now below the poverty line or are slightly above it would be affected the most. Even relatively small increases in prices further deteriorate the already adverse financial situation of the poor population. Besides, it is

[59] For more details see Arsić and Altiparmakov (2011).

very likely that the prices of electricity and public utility services will rise too, in addition to the VAT, which would affect the standard of citizens. If the prices of electricity and public utility services increased, this cost of increased prices would entirely spill over to end consumers. In parallel with the increase in VAT and administratively controlled prices, it is therefore necessary to apply adequate social welfare programs so as to alleviate the effects of the rise in the cost of living for the poorest citizens.

*Distribution of Burden of The Fiscal Consolidation*

Cutting private consumption expenditure in Serbia is necessary in order to bring the entire public spending in line with the overall production level in the country and with the low GDP level. With respect to the distribution of the fiscal consolidation burden, the Government faces the following options:

- To apply a balanced fiscal consolidation: increasing VAT and freezing public sector wages and pensions, and applying other austerity measures; or
- To apply an unbalanced fiscal consolidation: reducing public sector wages and pensions, whilst not increasing VAT; or
- To postpone fiscal consolidation: continuing to finance the spending by borrowing until the public debt crisis (i.e. no substantial austerity measures are undertaken nor are there increases in taxes). In this case, the burden of fiscal consolidation will be postponed only temporarily only to pay higher price not long afterwards in the form of a public debt crisis.

Each of the above options entails different distribution of the fiscal consolidation burden to be borne by specific population categories and a different percentage of reduction in the total real personal income.

Due to the increase in VAT and freezing of wages and pensions, the reduction in private consumption expenditure will affect all citizens, but the above average costs will be borne by the citizens who receive wages from the public sector (public administration, medical staff, education staff, policemen, army staff, etc.) and pensioners. Should the public sector wages and pensions be cut, fiscal consolidation would to the greatest extent affect the citizens whose income (wages and pensions) come from the public sector. Given that the public sector wages in Serbia are higher than those in the private sector, their real or even nominal reduction would partly remedy the distortion in the Serbian labour market. Reduction of public sector wages, in comparison to those in the public sector, is justified also because the likelihood of job losses in the public sector is much lower. The ratio between the average pensions and average wages in Serbia is larger than in other countries (approx. 60 percent), so a way to bring this ratio back under a sustainable framework (of approx. 50 percent) is to freeze pensions provisionally.

In case of public debt crisis, income and private spending of most citizens would fall, but the heaviest burden would be borne by the citizens who would lose their jobs due to the fall in GDP. From the point of view of economic efficiency, but also fairness, it would be better to opt for a real decrease of public sector wages and pensions in the fiscal consolidation by several percentage points rather than to expose the country to a debt crisis the solving of which would demand even bigger decreases of public pensions and wages, while dozens or even hundreds of thousands workers in the private sector would be laid off, which means that their wages would fall by 100 percent.

The fall of the average personal income would vary in each of the above scenarios. The fiscal consolidation in a form presented in the first two options would lead to short term slow-down of business activities, but it would also remedy the fiscal and foreign deficit and slow down the growth of public and foreign debt, thereby creating conditions for a long-term growth of economy. The fall of real personal income would be temporary in nature and it would constitute a sort of (unavoidable) price for returning of the Serbian economy to the path of sustainable growth in the long run. However, in absence of a fiscal consolidation (reduction in fiscal deficit) public debt crisis is almost inevitable and it would result in a fall of business activities by 5-10 percent and in an additional, and considerable, unemployment surge. The fall of standard of living in this case would be the most sizeable and the most long-lasting, while the capacity of the State to protect the poorest population strata would be at a minimum. Therefore, Serbian Government faces a choice of whether, through fiscal consolidation, to decrease public and private spending in an organized way, applying the appropriate social welfare measures, or to let the decrease of the living standard occur uncontrollably in the form of public debt crisis.

Given the above, all costs of fiscal consolidation, such as the increase in prices or costs of public debt crisis will be borne – in any and all cases – by the citizens of Serbia. Some of these expenses, such as the abolishment of annuities, are socially and economically justified, while other are economically necessary but will have, at least temporarily, adverse social consequences such as the fall in the standard of living or rise of unemployment. Therefore it is important to take into account the costs of the necessary fiscal consolidation during the designing of reforms, but it is important that they be as low as possible, that the citizens' standard of living last for as short period of time as possible as well as to protect the most disadvantaged groups of population.

### 4.3. Aid Measures for the Most Disadvantaged Population Strata

Rise in the VAT rate and increase in prices of electricity and public utility services will bring about a decrease in the standard of living of all population strata. In macroeconomic terms, decrease in private spending of citizens and public spending of the state[60] is necessary because the continuation of the financing of excessive spending through borrowing is not sustainable. The temporary fall in the standard of living is a price to be paid for bringing back the economy to the path of sustainable economic growth in the long term.

***The following measures are recommended:***

1. In order to safeguard the standards of the poorest population strata, social welfare schemes which are conditioned on the financial status of the beneficiary would be exempt from freezing. More specifically, this means that the family financial security (FFS) and the child benefits would be indexed on a regular basis by the amount of the increase of consumer prices. In this way the actual value of these benefits would be protected from inflation generated by the rise in taxes and administratively controlled prices.

2. In addition, it would be desirable to exempt the minimal pensions from freezing as well, in order to avoid deterioration of standards of the poorest pensioners.[61]

3. An additional temporary form of social assistance to the poor citizens could be provided for through the creation of an *ad hoc* social assistance budgetary fund from which

[60] Public consumption equals the value of services delivered by the government to citizens at prices which equal the costs of production of these services. The costs of production of government services equal roughly the sum of wages of employees in the public sector and operating expenses incurred in service delivery. Therefore, decreasing public spending implicates decrease in labor costs (less employees and smaller wages) and decrease in costs of goods and services (efficient public procurement).

[61] This entails that the pension indexation is applied only in case of pensioners who do not benefit from additional pensions from other countries.

additional benefits would be awarded once or twice a year. This fund could be financed partly by savings made in social assistance schemes which are not conditioned on the financial status of the beneficiary, and partly through savings in other budgetary positions.

4. Besides, it would be desirable to include local governments in the social care of the poor, which is already a case with some local governments. Regardless of the way in which the Law on the Financing of the Local Self-Government is amended, local governments will have at their disposal more funds than it was the case from 2006–2008, so they could use part of the funds for social protection schemes. Local governments could also cover, with their social protection schemes, those citizens who are in adverse financial position but are not receiving benefits from the State budget. However, even in this case selectiveness and targeting is necessary in order for the funds to reach the individuals who need it most. Therefore advantage should be given to measures focused on assisting families in a state of extreme poverty instead of measures that are not conditioned upon the financial status of the beneficiary (e.g. encouraging population policy).

*Social Acceptability of Fiscal Consolidation*

In any democratic society it is important that the majority of citizens support economic policy measures. Of course, this is not easy to achieve if the economic policy measures cause, at least in short-term, a decrease in the standard of living which is on average already low in Serbia. Therefore, for a social acceptability of increase in taxes and administratively controlled prices it is important that the citizens understand that such measures are necessary so that economic stability may be ensured as well as the future progress of economy and society. In this context, it is important to present in a clear manner any alternatives to these measures and the costs that such alternatives entail. In this particular case, the alternative is a debt crisis with significantly higher costs manifested in the fall of employment and actual value of personal income. In order to obtain support of citizens for reforms it is important to take short-term measures for reducing unproductive expenditure in the public sector.

The importance of social acceptability of fiscal consolidation can be illustrated by examples from the more recent economic history. On the one hand, there is the positive example of the Baltic countries which stepped into the crisis with a very high fiscal and external imbalances only to remove a significant portion of those imbalances through a radical fiscal consolidation which included a nominal decrease in wages and pensions, as well as increase in taxes. Fiscal consolidation was carried out with no significant internal resistance (strikes or rallies) and after a short-lasting fall in economic activities it resulted in a renewed economic growth. On the other hand, there is the negative Greek example where the wider public was strongly opposed to fiscal consolidation, which resulted in a slow-down of its implementation. As a result, the GDP and employment dropped sharply with vague prospects of recovery, whereas in order to establish fiscal sustainability it is necessary to have an increasingly strong fiscal consolidation. Also, Slovenia, which was one of the most successful transition countries before the current crisis, now faces serious fiscal problems as it has not succeeded in reducing its fiscal deficit and stopping the growth of public debt due to public resistance.

Examples of unproductive spending in the public sector are numerous: purchase of products and investment services at higher prices than market prices, recruitment of unnecessary workers in a non-transparent manner, duplicating of efforts in various state institutions, a large number of ministries, worryingly fast growth of the number of agencies, etc. Therefore it is important that the Government take decisive action to cut the above non-productive spending even if they do not have a substantial effect on the balance – as this constitutes an important sign of a fairer distribution of fiscal consolidation costs and strengthens the willingness of citizens to accept austerity measures.

Suppression of informal economy too, especially where some tax payers have privileged status, would help increase citizen support for the austerity measures.

From the point of view of political and social stability it is essential that the majority of citizens accept that a powerful and rapid fiscal consolidation, which is necessary in order to prevent the debt crisis, cannot be realized by abolishing unproductive spending only, by eliminating corruption and grey economy, but it is crucial to increase taxes and freeze pensions and wages in the public sector.

Therefore it is extremely important to question, in a well-argued manner, certain opinions that are voiced by certain segments of a wider public, whereby unproductive spending in the Serbian public sector is extremely overestimated. For instance, it is claimed that 40 percent of employees in the public sector, i.e. 175 thousand employees, is redundant, and that dismissing them from their jobs would solve the problems in public finances. Laying off 175 thousand employees in the public sector would endanger the core functions of the state: security, public education, public health, social welfare, etc. (see chapter on the employment in the public sector). A possible growth of income from suppressing grey economy is overestimated in a similar way when it is claimed that grey economy covers around 40 percent of the GDP and that taxing the grey economy could provide an addition billion of Euros in budgetary income in short term, thereby reducing the deficit by around 3 percent of the GDP. Even though there is no doubt that there is room for suppressing grey economy, additional income capability is considerably lower, and more significant results can be expected only in the mid-term, after the taxation administration has been reformed and overall fiscal discipline in the economy established.

Also, tackling corruption in a decisive and unselective manner and discontinuing of channels for a privileged accumulation of wealth will bring to the public sector additional savings, which are taken into account in the proposed program, but they are one level below the level attributed to it by the wider public. Eliminating unproductive public spending, including corruption, is important not only for fiscal savings to be achieved in this manner, but also in order to create a sound business environment in which entrepreneurship, rather than privileges, would constitute the main factors of success in the market and society as a whole.

For a social acceptability of fiscal consolidation it is important to remind the citizens of the things that they get from the public sector: most of the children are born in state-run maternity units, they go to public kindergartens, finish public schools, get medical care at public hospitals, they use public roads, the state safeguards the personal and property security of its citizens, disadvantaged citizens receive social assistance benefits, most of the old-age benefits are provided for through state pensions. Improving public sector services, starting from typical administrative services to educational and health care services to efficient building of infrastructure, would also increase the willingness of citizens to accept the necessary fiscal consolidation measures.

## 5. FISCAL CONSOLIDATION AND ECONOMIC GROWTH

**Current trends and problems**

High level and inadequate structure of public expenditures have negative influence on sustainability and the dynamics of the economic growth in Serbia. Among the comparable European states in transition, Serbia is one of the record holders of share of public expenditures in GDP (47.9 percent), which has a negative effect on the private sector development and entrepreneurial initiative. The structure of public expenditures is dominated by non-productive current expenditures, at the expense of lower investments and productive current expenditure. The tax system structure has an insufficient influence on the economic activity and sustainable economic growth. High level of fiscal deficit increases the foreign-trade deficit, enables depreciation pressures on dinar and endangers macroeconomic stability which represents a necessary condition for economic growth. High level of public debt increases country's credit risk and the level of interest rates, which has a negative effect on the borrowing conditions for economy and slows down investments and economic growth.

**Proposed measures**

1. Decrease of public expenditures share in GDP for about 4 percentage points over the medium-term.
2. Change the public expenditures structure with the aim of decreasing non-productive current public expenditure and increase of public investments and productive current expenditure.
3. Implementation of taxes reform which would have a positive influence on business environment and a sustainable economic growth – by removing/limiting surcharges and fees on businesses and by shifting from taxing labor to taxing consumption and property.
4. Decrease of fiscal deficit and decrease of public debt share in GDP.

**Expected effects**

Fiscal consolidation will not largely influence the economic activity in a short-term, while the effects on economic growth over the mid- and long-term could be positive. Fiscal consolidation will provide more favorable financing for economy, due to the decrease of the risk premium and the volume of state borrowing on the domestic financial market. In long-term, fiscal consolidation will have a positive influence on economic growth by stimulating the development of private sector and private initiative, rebalancing Serbian economy from consumption toward exports, increase of competitiveness due to the effect of fiscal devaluation, as well as providing for predictable business environment. Decrease of fiscal deficit and public debt will also influence the decrease of foreign-trade deficit, stabilization of the value of RSD, decrease of interest rates, which will have a positive impact on macroeconomic stability and creating favorable conditions for economic growth.

***Theoretical models and empirical research clearly show that fiscal policy and the structure of the public sector have a significant impact on economic activity - both in the short and the long term.*** In the short term, fiscal policy affects economic activity primarily through the channels of aggregate demand, changing its level and structure. In the long term, fiscal policy affects economic activity and economic growth through effects on the level and structure of aggregate supply - by determining the private and the public share of domestic production, affecting the level of accumulated physical and human capital, creating a system of economic incentives to economic actors. The level of public spending, and the structure of revenue and expenditure side of public finances affect growth performance, although the effects of the intensity of this impact vary from country to country due to different social, cultural and geographical conditions (Pitlik and Schratzenstaller, 2011). Hence we can expect that fiscal consolidation affects the economic performance of the Serbian economy - primarily through the effects of aggregate demand in the short term and through the impact on aggregate supply in the long term.

***Fiscal consolidation will, in the short term, impact on the economic activity through effects on aggregate demand.*** Proposed measures of fiscal consolidation include substantially reduction of public spending and a moderate increase in tax revenue, with significant changes in the structure of public expenditure and tax revenue. The proposed measures will affect the level and structure of aggregate demand in the short term. The planned reduction of public expenditures for the purchase of goods and services, freeze of pensions and salaries of the state sector employees, and a partly increase in tax burden will reduce aggregate demand. On the other hand, the planned increase in public infrastructure spending will cause an increase in aggregate demand, while fiscal consolidation will also allow indirect effects to increase aggregate demand by increasing private investment demand and an increase in net exports. Namely, the fiscal consolidation will allow the relaxation of monetary policy and partial reduction in domestic interest rates, which will stimulate private investment demand, and demand for durable consumer goods, purchase of which is financed through bank loans. In addition, fiscal consolidation includes measures that should increase the competitiveness of domestic producers and thus increase aggregate demand through an increase in net exports (net exports = exports - of imports). It is expected that the overall effect of fiscal consolidation will result in a partial/ modest reduction in aggregate demand in the short term.

***Although fiscal consolidation will have a negative impact on aggregate demand in the short term, it is expected that the intensity of the end-effects on the level of production and economic activity will be modest – due to the fact that Serbia is a small, open transition economy with a high share of imported goods, high external debt and flexible exchange rate regime.*** When considering the effects of fiscal policy and/or fiscal consolidation at the level of production and economic activity in the short term, the key issue is the magnitude of the *fiscal multiplier* – i.e. the extent to which the increase or reduction of public expenditure is transferred to the level of production and economic activity. International experience and empirical research show that the effects of fiscal multiplier in the transition states are considerably less than in developed countries, especially in case of small open transition economies like ours, with high external debt and a flexible exchange rate regime (Petrović, 2010). Also, the fiscal multipliers in case of public infrastructure expenditures are significantly higher than the multipliers of current public spending, especially in case of emerging economies - so that the planned changes in the structure of public spending, from the current to the investment one, could positively affect the level of production and economic activity. It can be expected that the level of production activities will be positively affected by the relaxation of monetary policy and the consequent reduction in domestic interest rates, which will be enabled upon the implementation of the fiscal consolidation measures. In general, the ultimate effect of fiscal consolidation would be a partially reduced aggregate demand and production in a short term after the implementation of austerity measures. However, given the above, we can expect that the aforementioned negative effects on economic activity will not only be short-lasting, but of a very modest scale - economic growth is expected to be reduced around 0.5% in the year following the fiscal consolidation.

***Despite the modest negative effects of the fiscal consolidation on economic activity (reduction of economic growth by about 0.5%) in the short term (about a year), decisive and credible austerity measures have no alternative if Serbia is to avoid a debt crisis and economic collapse similar to the "Greek scenario".*** International experience shows that developing countries such as Serbia, which, unlike developed countries, do not have high credibility with the repayment of debts, most often experience a crisis of public debt or bankruptcy at the debt level of 40% to 50% of GDP (Baldacci et al, 2011). The table 5.1 shows that at the end of the third quarter of 2011, Serbia was heading the list of the comparable European countries in transition. During 2012, Serbia exceeded the legally regulated public debt ceiling of 45% of GDP and it is expected that the public debt will be at around 55% of GDP at the end of the year. Hence, the serious and urgent austerity measures are necessary to stop the growth of public debt and avoid a debt crisis. It is clear that the eventual failure of Serbia to pay off its obligations, or the bankruptcy of the public finances would have enormous negative effects on economic activity in the country, such as further increases in unemployment, bankruptcies of private companies in the real sector, as well as the deterioration of the social status of citizens whose benefits are financed from the budget. However, it is important to note that even if the Republic of Serbia manages to avoid open bankruptcy of public finances, the current high level of fiscal deficit and public debt, is adversely affecting economic activity - the financing of budget deficit is crowding-out funds from the financial sector, thereby reducing funds available to the private sector and increasing the cost of these funds (so-called *crowding-out* effect), whereby high public debt increases the credit risk of the country, thus increasing the risk premium on the local financial market, which further increases the cost (interest) that private economic actors have to pay during their operations. These negative effects on businesses and (private) economic actors will continue in the future unless the Government of Serbia immediately reduces the budget deficit and stops the growth of public debt by applying decisive and credible austerity measures.

**Table 5.1 Public debt of European Countries in Transition, Q3 of 2011 (% of GDP)**

| Country | Public debt |
|---|---|
| Bulgaria | 15.0 |
| Czech Republic | 39.8 |
| Estonia | 6.1 |
| Latvia | 44.6 |
| Lithuania | 37.6 |
| Hungary | 82.6 |
| Poland | 56.3 |
| Romania | 33.3 |
| Slovenia | 44.4 |
| Slovakia | 42.2 |
| EU-10 average | 40.2 |
| Macedonia | 25.0 |
| Serbia | 45.0 |

Source: Eurostat, the Fiscal Council

***Fiscal consolidation contributes to the consolidation of macroeconomic stability in the short term and makes a positive impact on economic growth.*** Currently a very high fiscal deficit further increases the value of a high trade deficit, which, in the absence of foreign capital inflow, creates depreciation pressure on dinar. The high level of trade deficit and imbalances in balance of payments require the intervention of the National Bank of Serbia in the foreign exchange market, which use foreign currency reserves and increases the risk of balance of payments crisis. Therefore, fiscal consolidation is imposed as a priority for economic policy, not only to prevent the debt crisis but also the balance of payments crisis that could undermine macroeconomic stability and thus undermine one of the basic prerequisites for sustainable economic growth in coming years.

***It is necessary to adopt as soon as possible decisive and credible fiscal consolidation measures, especially on the expenditure side, in order to positively influence the expectations of economic actors and the financial markets, because these expectations will significantly affect the dynamics of recovery (or collapse) of the Serbian economy.*** It is generally known that expectations of economic actors have a huge impact on economic activity in the economic cycle. Expectations regarding the outcome of the fiscal consolidation have a strong influence on the path of economic recovery (or economic collapse) after the implementation of austerity measures. Austerity measures that are inadequately designed or implemented in an insufficiently decisive manner may arouse suspicion in economic actors regarding the success of fiscal consolidation and make them behave (in a conservative manner and with uncertainty) in the way that would further deepen the current economic crisis and thus increase the likelihood of economic and/or debt collapse. On the other hand, the decisive implementation of structural and well-designed austerity measures affects the creation of positive expectations of economic actors, who then, through their optimistic behavior (companies invest in new production facilities, people buy durable goods or properties) contribute to the increase of production and economic activity. In theory, the positive effects of positive expectations of economic actors can lead to increased production and economic activity, despite the implementation of austerity measures and fiscal consolidation.[62] Empirical studies are divided against the possibility of economic expansion due to the implementation of austerity measures and fiscal consolidation. While Alesina and Perotti (1995) show rather optimistic results, the results of the IMF (2010) are generally pessimistic when it comes to the possibility of economic expansion in the short term due to the implementation of fiscal consolidation.[63] However, the common conclusion of these opposing empirical results is the fact that fiscal consolidation based on the reduction of public expenditure impact on economic activity in a more positive or less negative way than the fiscal consolidations that rely on tax increases.[64] Another common finding is that, due to the existence of a large number of interdependent economic impacts, it is necessary to thoroughly analyze each particular case of fiscal consolidation separately, in order to determine in the most precise way (possible) effects on economic activity. In this context, the recent economic history provides an encouraging indication for Serbia. The decisive and credible fiscal consolidation measures that Latvia conducted in 2008 and 2009 have shown that positive expectations can produce very positive effects on economic recovery. Despite the drastic

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[62] The previously stated claim that the fiscal consolidation in the short term is likely to lead to modest negative effects on economic activity is in accordance with (neo) Keynesian economic theory. However, the inclusion of expectation effects can reverse this result and it suggests the absence of negative, or even the presence of positive, effects on economic activity - which is in line with modern new-classical economic theory and "Riccardian neutrality."

[63] With the expansion of the time horizon and the transition from short to long term - the effects of fiscal consolidation on economic growth are becoming unambiguously positive.

[64] Empirical studies also show that the fiscal consolidations based on the reduction of public spending are far more successful in reducing public debt and sustainable fiscal policy than the fiscal consolidations relying on tax increases.

austerity measures and fiscal consolidation, which Latvia implemented, the economic crisis in this country was of remarkably lower scope and lasted much shorter than the professional community, including the European Commission, expected. From the above it is clear that there is an urgent need for the Government of Serbia, to promptly adopt and implement important structural fiscal consolidation measures, primarily based on reducing public spending.

*Fiscal Consolidations in Transitional Countries*

The economic crisis and the decline in budget revenues forced the majority of EU member states to undertake far-reaching austerity and fiscal consolidation measures in the period since 2009 to date. For the upcoming fiscal consolidation, experiences of transition countries such as Romania and Latvia, and Croatia and Slovenia are the most important, since those countries, like Serbia, over-increased in an unsustainable manner their public spending in the prosperous years before the crisis.

Latvia and Romania are taken as positive examples of (transition) countries that have implemented the most rigorous austerity program in recent years. Both states have substantially reduced salaries in the public sector, 30% and 25% respectively, and joined the rationalization of the number of employees. Romania has also reduced the amounts of social assistance by 15%, leading to negative social effects and partly reduced the social support for the fiscal consolidation measures. Initially, both states planned the reduction in public pensions; however, they were forced to abandon this action, since it was deemed unconstitutional. Due to the impossibility to reduce pensions, tax revenues were substantially increased - VAT increased by 5 percentage points in Romania, and Latvia has increased VAT by 4 percentage points and the income tax by 3 points.

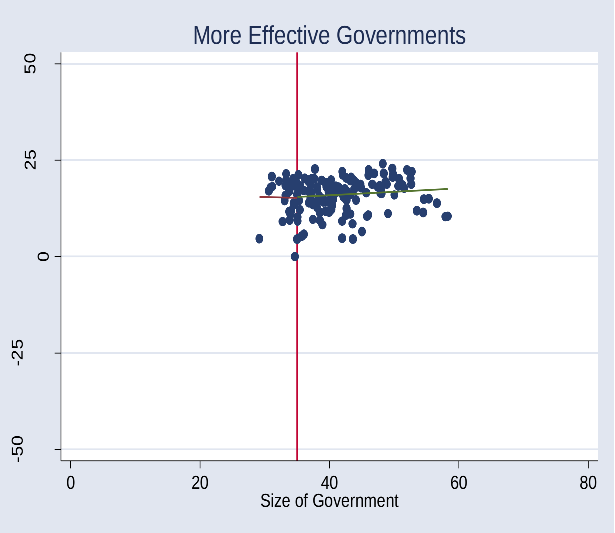
The experiences of Croatia and Slovenia are also valuable for Serbia, since these countries share extensive social heritage with Serbia. Like Serbia, Croatia and Slovenia largely delayed the necessary fiscal consolidation measures in recent years due to lack of political and social support. Newly elected governments in these countries have announced major measures of fiscal consolidation during 2012, which should primarily be focused on reducing government spending while keeping more or less the same level of tax burden. However, lack of social support leads to uncertainty regarding the success of fiscal consolidation in both countries. The initial plan of the Slovenian Government, which implies a reduction in public sector wages by 10% and rationalization of the number of workers, especially in the field of education – was not supported by trade unions, and caused massive strikes which so far have prevented the government to implement their plans into action. On the other hand, the newly elected Croatian government in February 2012 adopted a revised budget which provides some reduction in public spending. However, the planned reduction in public spending is not based on structural austerity measures, but is primarily based on *ad hoc* cuts in discretionary expenditures, so that the viability and sustainability of the austerity measures adopted in Croatia is questionable. The Croatian government has also, in May 2012, conducted a tax reform aimed at improving the business environment and competitiveness of the economy – by reducing burden on wages, and increasing the tax burden on consumption and capital, while quasi tax burdens are considerably limited. To sum up, the apparent lack of social support for the inevitable fiscal consolidation measures in Slovenia and Croatia makes the economic recovery in these countries more difficult, increasing thus the risk of debt crisis and the "Greek scenario".

***Although the general public often talks about short-term effects on economic activity, actually the most important effects of fiscal consolidation are related to the dynamics of long-term economic growth in Serbia.*** In the professional public, both local and foreign, there is consensus that economic development model of the previous decade, which implied a substantially higher consumption than the domestic production and financing of that difference through the foreign capital inflows - is no longer viable (Bajec, Petrović, Stamenković et al., 2010, World Bank, 2012). Inadequate fiscal policy has contributed to an unsustainable model of economic development, given that public finances often recorded high deficits despite strong economic growth over the past decade. A new, sustainable model of economic development in Serbia involves reduction of consumption (both public and private) in GDP, with a parallel increase in savings, investment and net exports. One of the key preconditions for avoiding economic collapse and transfer to a sustainable model of economic development is a reform of public finances and implementation of fiscal consolidation which would eliminate the large structural fiscal deficit which is in Serbia over 4% of GDP.

***Sustainable economic growth in the current decade (and in the future) will be essentially dependent on the implementation of proper fiscal consolidation - consolidation must be over 4% of GDP in order to eliminate the high structural deficit, and the consolidation should be based primarily on austerity measures and on reduction of the public consumption***. The fiscal deficit in Serbia is not a short-term effect of the economic crisis, but is of long-term nature due to the structural imbalance of public finances created in the period 2006-2008 – through an unsustainable increase in pensions and public wages and unsustainable cuts in wage taxes. The imbalance of public finances was further deepened in late 2011 through fiscally unsustainable transfer of funds from central to local levels of government, without a corresponding transfer of public functions to local level. In theory, imbalance of public finances could be eliminated by increasing taxes, at least in the short term. However, international experience of recent decades shows that fiscal consolidation based solely or primarily on tax increases are usually not sustainable or successful in terms of stabilization of public debt - the most common outcome of this consolidation was the need for further austerity measures in the near future. Possible consolidation of public finances that in Serbia would be primarily based on tax increases would further burden the Serbian economy and reduce its competitiveness - which would slow economic growth and jeopardize the success of fiscal consolidation and economic recovery. Possible further (significant) increase in the tax burden would further worsen the problem of the gray economy and tax evasion, which is already very high and represents an increasing impediment to economic development (of legal part) of the Serbian economy.

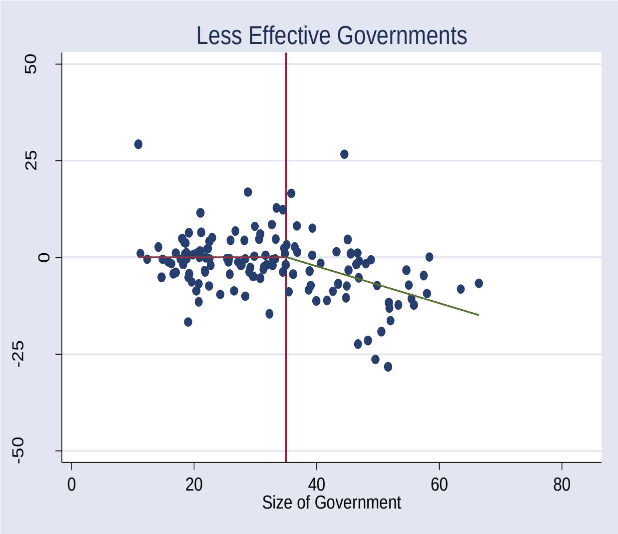
***Fiscal consolidation based on austerity measures and reduction of public expenditure is also required having in mind the fact that the public sector in Serbia is one of the largest in comparison with other transition countries of Europe - which will negatively affect economic growth and competitiveness of Serbian economy in the coming years.*** International experience has shown that in case of developed countries, a large government sector does not necessarily have a negative impact on economic growth, due to the efficient and transparent functioning of the institutional framework in developed societies. The Scandinavian countries are often taken as a typical example of countries where a large public sector has not adversely affected economic growth in recent decades. However, in developing countries, which are usually characterized by inefficient institutions and non-transparent functioning of the public sector, and where high level of corruption is present - international experience suggests that the negative effects economic growth emerge when public spending becomes greater than 35% to 40% of GDP (Graphs 5.1a and 5.1b). As shown in the table 5.2, Serbia, along with Slovenia and Hungary, has the largest public spending of all transition countries in Europe, we can easily conclude that the reduction of public spending imposes a priority if Serbia is to avoid fiscal collapse and achieves high rates of economic growth in coming years and remain competitive among the other transition economies in the region.

**Graph 5.1a Impact of the Size of Government Sector on the Economic Growth – Developed Countries**




Source: World Bank (2007)

**Graph 5.1b Impact of the Size of Government Sector on the Economic Growth - Transitional Countries**




Source: World Bank (2007)

***In addition to the size of government spending, the structure of expenditure and revenue side of budget strongly influences economic performance in the long term***. In the long term, fiscal policy affects economic performance through aggregate supply channels. In this context the structure of budget expenditure is important - the share of public investment, and productive current expenditure versus the unproductive current expenditures. Public investment in infrastructure increases the accumulation of (physical) capital in the country, which will enable more efficient and productive domestic production in the coming years. Also, spending on education increases human capital, which will be available in the production process in the years and decades to come. On the other hand, spending on pensions and public sector salaries are forms of public spending that is not affected (in a direct way) to increase the productive capacity of the state in the future[65]. When it comes to the structure of the budget revenues, taxes affect the aggregate supply through systems of incentives they cause at economic actors - tax systems encouraging work and employment impact more favorable on economic growth of the tax systems that encourage (or do not penalize) inactivity or idleness.

**Table 5.2 Share of Government Spending in GDP (%) – Transitional European Countries, 2011**

| Country | Public expenditures |
|---|---|
| Bulgaria | 35.2 |
| Czech Republic | 43.4 |
| Estonia | 38.2 |
| Latvia | 39.1 |
| Lithuania | 37.5 |
| Hungary | 48.7 |
| Poland | 43.6 |
| Romania | 37.7 |
| Slovenia | 50.9 |
| Slovakia | 37.4 |
| EU-10 – average | 41.2 |
| Serbia | 47.9% |

Note: Serbian government spending is presented in accordance with the international methodology stipulating that the contributions paid by employer (1.9% of GDP) are not consolidated.
Source: Eurostat, Fiscal Council

***In order to stimulate economic growth, it is necessary to change the structure of public spending in Serbia through increased public investment in infrastructure and the reduction of current public spending.*** As mentioned, public investments increase the accumulation of physical capital and thus enhance the production capacity in coming years. Public investment has been rather neglected in the past two decades, resulting in a poor condition of infrastructure, which reduces the competitiveness of Serbian economy in the countries in the region. Hence in future it is necessary to increase public investment in infrastructure, particularly in the transport network and power system. Also, within the current public expenditures, it is necessary to change the structure and reduce unproductive expenditures, such as expenditures for supernumerary public agencies or non-productive state subsidies in order to provide funds for productive current expenditure such as expenditure for education or for well-targeted social protection programme.

***In addition to changing the structure of public spending, it is necessary to significantly increase the quality of services provided by the public sector in order to improve development opportunities of the Serbian economy.*** First of all, it is necessary to improve the quality of services provided by the judicial system, in order to more effectively

[65] Public sector salaries are disproportionately high relative to comparable private sector salaries, which negatively affects the competitiveness of the domestic economy and economic development (see Chapter 7).

suppress corruption and ensure a secure legal environment which presents an essential prerequisite for efficient and competitive business environment. Also, it is necessary to improve the service quality of the education system and align it with the needs of the economy, given that inadequate educational profile of the workforce is one of the causes of the poor state of the labor market. It is necessary to improve targeting of social welfare programs, since only about one-quarter of total social expenditure is adequately targeted (MOP and child allowance). Also, it is necessary to increase the efficiency of public investment through the establishment of systems for assessing the usefulness and cost effectiveness of alternative investment projects (*cost-benefit* analysis).

***Economic growth can be stimulated by the comprehensive tax reform that would reduce the fiscal burdening of labor and increase tax burdening on consumption and property, while the quasi taxcharges would be abolished or restricted.*** Transferring the tax burden from labor to consumption would create an effect of *fiscal devaluation*, which would reduce unit labor costs in Serbia and increase competitiveness of domestic producers. The proposed tax reform measures (Chapter 12), implying the reduction of fiscal levies on salaries and an equivalent increase in VAT, would result in a reduction in unit labor costs by nearly 7% on average, which would make domestic producers more competitive in the domestic market and foreign markets. Increased taxation of property, primarily of unused land, would lead to more efficient allocation and use of resources and a more complete activation of unused potentials for productive purposes. This would allow the enlargement of agricultural holdings and increase the competitiveness of Serbian agriculture; given that the fragmented land holdings reduce the productivity of agricultural production in comparison to comparable European countries. International experiences speak in favor of the thesis that the tax reforms that transfer the burden from labor to consumption and property have a positive effect on economic growth (OECD, 2010). Quasi tax levies does not make much of the total fiscal revenues, 1-2% of GDP, however, they significantly undermine the quality of business environment due to their volatility, disproportion with respect to the taxpayer's ability-to-pay and the fact that they often present a barrier to the entry of new economic actors on the market (NALED, 2012). Hence the cancellation and / or restriction of quasi tax levies represents one of priorities for the tax reform that would stimulate economic growth in Serbia.

# PART TWO:

# FISCAL CONSOLIDATION: SECTORAL ANALYSES

# 6. FISCAL SUSTAINABILITY OF THE SERBIAN PENSION SYSTEM

**Current trends and problems**

During the previous decade, there have been significant systematic reforms with the aim of establishing a sustainable pension system in the Republic of Serbia. However, two significant irregular pension increases during 2008 (11 percent in February and 10 percent in October) have seriously destabilized the sustainability of the pension as well as the entire fiscal system. Pension share in GDP of more than 14 percent still makes Serbia one of the European record holders, along with Italy and Austria. Also, parameter reforms of the pension system haven't been finished, which creates negative economic incentives for citizens to retire before their actual retiring age.

**Proposed measures**

1. Temporary freezing of pensions, so that the share of pensions in GDP could be brought to the level which domestic economy can cope.
2. Introduction of the factor of actuarial equity, so that the citizens are discouraged to retire before their actual retiring age.
3. Gradual increase of retirement age for women, in order to decrease the unjustified difference of five years between retirement age for women and men. One option is a gradual increase of retirement age in phases, for six months in a calendar year, so that the age limit for the retirement of women at the end of the transition period of six years comes to 63 years of age.
4. Considering options for introduction of the system of automatic stabilizers which would ensure that the standard and minimal retirement age follows the changes in the life expectancy in the following decades.

**Expected effects**

Freezing of pensions during one calendar year will bring fiscal savings of around 0.4 percent of GDP, while the factors of actuarial equity will save around 0.1 percent of GDP, in the first few years, and these savings would increase in the course of the next 15 years up to the balanced level of around 0.4 percent of GDP.
Introduction of the factors of actuarial equity, gradual increase of age limit for women retirement and inclusion of the system of automatic stabilizers will contribute to the increase of effective age for retirement, which will provide fiscally more sustainable and socially more righteous structure of pension system in the following decades.

***At the beginning of transition, Serbia had an unsustainably "generous" Bismarck-type pension system, which had not been adjusted with the actual demographic processes and economic capacities of the Serbian economy over a long period of time.*** The legal link between the pension contributions paid during one's service and the level of one's pension benefit was very weak, the system was overburdened by a huge number of (unjustified) disability benefits approved during the 1990s, and the ratio of the registered insured persons and pension beneficiaries was 1.5 workers per one pension beneficiary. In 2001, in line with countries such as Germany or Austria, Serbia adopted a reform direction that implied parametric reforms to ensure that the state pension system (financing expenditures with funds that are currently available, PAYG) is fiscally sustainable in the long-term period and that it continues to be the dominant source of revenue for the majority of elderly population. An option was left for the high-income population to relay to a greater extent on private pension savings in their old age – by introducing private tax-preferred pension funds in 2005.[66] Due to its high transition costs and underdeveloped capital markets, Serbia did not consider seriously the possibility to partially capitalize the statutory pension insurance segment – which was done in Croatia, Hungary or Bulgaria, which introduced statutory private pension funds, or by Slovenia and Republic of Srpska, which created state pension reserve funds.[67]

***The pension reform process in Serbia was initiated by resolved and significant public Pay-As-You-Go pension system parametric reforms.*** In 2001 and 2002, a point-based pension benefit calculation system was introduced, implying a transition from the pension benefit calculation based on the "10 best years" to the calculation based on the overall service, as well as the statutory retirement age increase for three years – from 55 to 58 years of age for women, and from 60 to 63 years of age for men.[68] In addition, a shift was made from the pension valorization and indexation 100% in line with wage inflation to a combination of 50% wage inflation and 50% price inflation. The possibilities for retiring before the statutory retirement age were limited and the disability benefit criteria were made considerably more stringent – due to a huge number of unjustified cases during the 1990s. The pension system parametric adjustments were continued in 2005, with the retirement age increased for additional two years (65 years of age for men, and 60 years of age for women, with a transitional period until 2011), and a shift to the pension valorization and indexation in line with the price inflation only.[69] However, the 2005 legal changes included also increased possibilities for retiring before the statutory retirement age – in spite the fact that Serbia was already among the negative European record holders in this segment (Graph 6.1). The most recent pension system parametric adjustments were implemented in 2010. On that occasion, the list of professions and posts eligible for extended pension span credited and retirement before the statutory retirement age was narrowed down – the minimum retirement age was increased from 53 to 58 years of age (for both men and women), with a long transitional period until 2023.[70] The level of positive discrimination of women in the pension system, by crediting increased years of service, was reduced from 15% to 6%, with a transitional period until 2023. In addition, the 2010 legal changes stipulated pension valorization and indexation in line with the price inflation, increased by the real GDP growth exceeding 4%.[71]

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[66] Approximately 8% of employed workers in Serbia currently save in private pension funds.

[67] The state pension reserve funds established in some Eastern European countries do not present serious forms of pension system capitalization due to extremely modest funds allocated for that purpose.

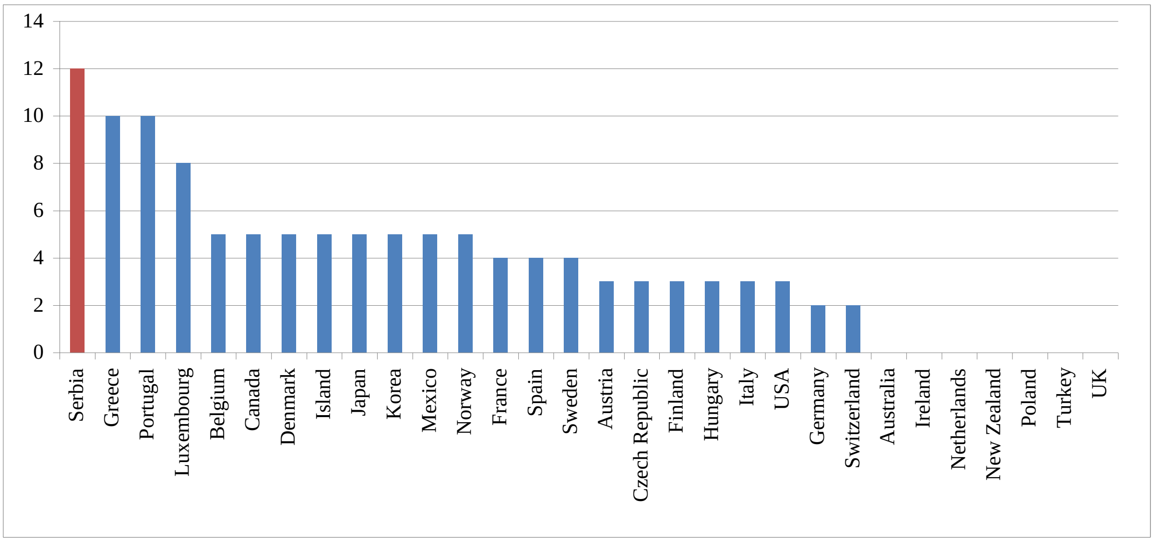
[68] Due to a lack of necessary pension system parametric adjustments during the 1990s, the above changes did not come into force without a transitional period. Similar parametric reforms in Croatia, Slovenia or Slovakia were implemented with a multiyear transitional period.

[69] Valorization refers to the process of adjustment of the contributions paid during one's service for the purposes of calculating the initial pension benefit level, while indexation refers to the regular process of adjusting the pension benefit levels after retirement. For more information about the terminology and characteristics of different pension systems see Whitehouse (2006).

[70] Specific professions can still retire before completing 50 years of age, while the minimum retirement age for workers eligible to have extended duration of pension span credited was increased from 53 to only 55 years of age.

[71] During the transitional period, until 2013, pension benefits will be valorized and indexed in line with inflation and one half of the actual GDP growth.

**Graph 6.1 Difference between Statutory and Minimum Retirement Age for Men in Selected Countries (in Years)**




Source: World Bank (2009)

***Before the adopted parametric reforms started resulting in considerable fiscal savings, the financial stabilization of the pension system had been suspended by two additional and considerable pension increases in 2008.*** In addition to the regular April and October pension indexations, by 7% and 4% respectively, in 2008, pensions were additionally increased by 11% in February and by 10% in October. The additional February pension increases, even though stipulated in the transitional legal provisions, were, to the greatest extent, unjustified, and were a consequence of an inadequate statistical coverage that caused the average registered wage in Serbia to be overestimated by some ten percent in 2007 and 2008.[72] The additional 10% pension increase in October 2008 came about as a result of pre-election promises. The overall effect of the pension benefit increase was as much as 21% real year-to-year average pension increase from October 2007 until October 2008. Such a high real pension increase undermined the public finance stability in Serbia and resulted in the pension expenditures reaching 15% of GDP in 2009.[73] The destabilization of the public finance system, parallel with the overflow of the global economic crises to Serbia in 2009, called for emergency rationalization measures, which included a two-year freeze of nominal pension benefit levels (and public sector wages) in the period 2009–2010. The pension freeze measure gave results and in 2011 the pension expenditures came down to 14% of GDP (Graph 6.2). However, 14% pension expenditures as a share of GDP still puts Serbia among the negative European record holders, together with Italy and Austria (Table 6.1). Considering the economic characteristics of the Serbian economy, 14% pension expenditures as a share of GDP cannot be sustainable in the long term in any way. That is why the Budget System Law stipulates the fiscal rules specifying that the pension expenditures need to be reduced to a

[72] The transitional legal provisions stipulated that the average pension level cannot fall under 60% of the wage in Serbia in 2007 and 2008. However, by having excluded almost a quarter of a million of the lowest-waged workers, employed with entrepreneurs, the official statistics considerably overestimated the actual average wage in Serbia in these years. The methodology for the calculation of average wage was corrected at the beginning of 2009.

[73] The increase of pension expenditures as a share of GDP in 2009 results to a smaller extent also from a downfall in economic activity due to the economic recession.

sustainable level of 10% of GDP – which is more or less the average (or even the upper end) for the European transition economies with similar economic characteristics as Serbia.

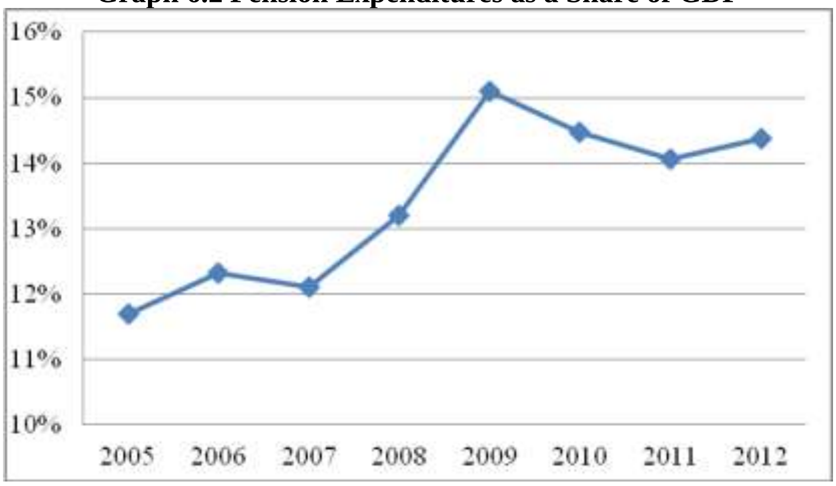
*Does PAYG Financing of the Pension System in Serbia Has an Alternative?*

While there is a wide-spread public perception that the capitalized systems are *a priori* superior to the PAYG pension systems, the truth is that the capitalized systems are more efficient only if they can generate capital yield at a rate exceeding the economic growth rate. Otherwise, the *Pay-As-You-Go* (PAYG) pension systems, based on financing expenditures with funds that are currently available, are more efficient and can ensure higher pension benefit levels for the same amount of contributions paid during one's service – the so-called *Samuelson-Aaron Theorem.*

In this context, it is not realistic to expect that a prospective partial capitalization of the statutory segment of the Serbian pension system, either in a form of a state pension reserve fund or by introducing statutory private pension funds – could ensure a system that would economically be more efficient than the actual PAYG financing. More specifically, a severely underdeveloped national capital market, poor public finance management, which is characteristic of transition economies, as well as a disappointing performance of the statutory mandatory private pension funds in most Eastern European countries – speak in favor of the thesis that the benefits from a prospective capitalized segment of the Serbian pension system would be lower than the economic growth and imputed yield rate of the current PAYG system (Altiparmakov, 2012).

In addition, a meaningful capitalization of the Serbian pension system would require between EUR 10 and 15 billion, at net present value. It is not realistic to expect that the public finance could support in the foreseeing future to finance such huge transition costs, since the required amount is approximately equal to the overall national public debt. If the above amount could be provided – an economically more efficient choice for Serbia would be to use the funds to repay the current public debt, instead of using it for the capitalization of the pension system.

**Graph 6.2 Pension Expenditures as a Share of GDP**




Note: Calculations include military pension expenditures.
Source: Fiscal Council

**Table 6.1 Pension Expenditures as a Share of GDP, EU 2010, Serbia 2012**

| | |
|---|---|
| Belgium | 10.0 |
| Bulgaria | 7.2 |
| Czech Republic | 7.6 |
| Denmark | 7.9 |
| Germany | 10.6 |
| Estonia | 9.3 |
| Ireland | 4.5 |
| Greece | 12.1 |
| Spain | 9.2 |
| France | 13.3 |
| Italy | 14.7 |
| Cyprus | 6.3 |
| Latvia | 6.1 |
| Lithuania | 7.6 |
| Luxembourg | 7.4 |
| Hungary | 10.6 |
| Malta | 7.2 |
| Netherlands | 7.0 |
| Austria | 13.9 |
| Poland | 11.3 |
| Portugal | 12.7 |
| Romania | 7.5 |
| Slovenia | 10.1 |
| Slovakia | 6.4 |
| Finland | 10.6 |
| Sweden | 9.6 |
| UK | 6.3 |
| Average - EU-15 developed economies | 10.0 |
| Average - EU-10 transition economies | 8.4 |
| **Serbia – 2012** | **14.0** |

Source: IMF (2011), Fiscal Council

***The Fiscal Council believes that the selected pension reform direction, which implies the parametric reforms to ensure a sustainable PAYG pension component and the introduction of voluntary pension funds targeting high-income population – was an optimum choice, considering the economic characteristics and potentials of the Serbian economy.*** However, in the coming period, it is necessary to finalize the parametric reforms initiated in the previous years – to ensure and maintain the sustainability of the public PAYG in Serbia.

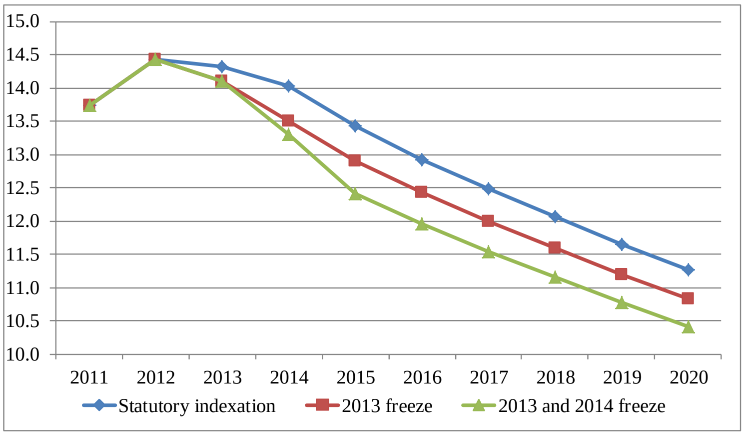
***The basic economic scenario projection shows that the pension expenditures as a share of GDP in 2020 will be over 11%.***[74] However, the fact that the pension expenditures would be considerably higher than 11% of GDP throughout this decade indicates extremely high pension system financing pressures that would have to be borne by the Serbian economy in relation to the comparable European transition economies. This disproportion between the current expenditures for pensions and the capacities of the national economy is reflected also in the fact that the average (net) pension/wage ratio in Serbia is a little above 60%, while in most Eastern European countries (Macedonia, Montenegro, Bulgaria, Romania, Czech

[74] This projection assumes the growth of the number of pension beneficiates at the rate of 1.3% annually.

Republic and Slovakia) this ratio varies around 50%, and in Croatia it is only 40%. Only Slovenia and Hungary have the average wage/pension benefit ratio at approximately 60%, but these countries too have major problems with the (un)sustainability of the pension system and the overall fiscal system.[75]

***In the short term, the only possible pension expenditure stabilization measure is the nominal pension freeze.***[76] A prospective pension freeze in 2013 would result in the fiscal savings of approximately 0.4% of GDP annually, starting from 2014.[77] A prospective pension freeze in 2014 as well would result in the additional fiscal savings of 0.4% of GDP annually, starting from 2015 (with 4% projected inflation in 2014). A pension freeze in 2013 and 2014 would enable bringing the share of pension expenditures closer to the target level of 10% of GDP in 2020 (Graph 6.3). Weather it would be necessary, as a part of fiscal consolidation, to freeze pensions for one or two years depends on the fiscal circumstances in the other parts of the public sector, i.e. on the savings that can be generated on the other current expenditure items – public sector wages, public procurement, and expenditures for goods and services.[78] Considering the current significant fiscal imbalances, neither the option of one-time partial pension cuts, nor the option of taxation of pensions above a certain level can be *a priori* excluded. It is clear that in the medium term, at least during this decade, it is necessary to persevere with the adopted pension indexation formula, which implies indexation in line with inflation and GDP growth exceeding 4%. A prospective transition to another form of a more generous pension indexation formula would undoubtedly undermine the already frail stability of the pension system, and would undermine the overall fiscal sector.

**Graph 6.3 Pension Expenditure Projections in the Coming Decade (% of GDP)**




Note: Pension expenditures include military pension expenditures.
Source: Fiscal Council Projections

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[75] The average wage/pension benefit ratio is used, in this context, as an indicator of the overall abundance of pension systems, and not as an indicator of the adequacy of pension benefits – considering that the statistics includes disability and survivor's pensions in the average pension. In the context of the adequacy of pension benefits, it can be noted that the ratio of the average old age pension for beneficiaries with full service completed and the average wage in Serbia is exceptionally high, at almost 90%. However, only 20% of pension beneficiaries in Serbia have full years of services completed.

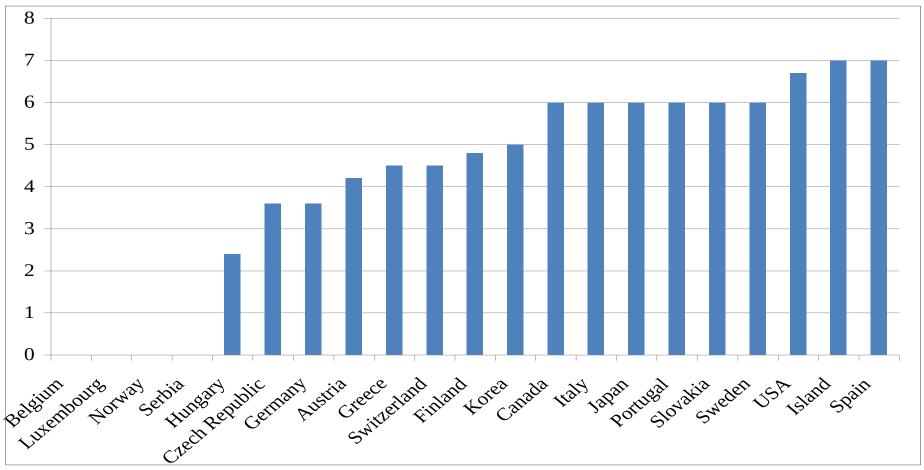
[76] While the parametricchanges, such as the introduction of actuarial penalties, which is described below, are necessary to ensure a long-term sustainability of the pension system, they cannot ensure notable short-term savings.

[77] With 4% projected inflation in 2013, the fiscal savings in 2013 would be approximately 0.2% of GDP, considering that the freeze would be implemented effectively in the second part of the year.

[78] In case of a prospective pension freeze, there is a possibility not to freeze the indexation of the minimum pension level to protect the living standard of the lowest-income pensioners.

***In the short term, it is necessary to introduce actuarial penalty factors for retiring before and after the statutory retirement age and (partially) increase the retirement age for women.*** The lack of actuarial penalties for retiring before the statutory retirement age, i.e. actuarial rewards for retiring after the statutory retirement age – is the major parametric deficiency in the actual pension system in Serbia. Any financially sustainable pension system design must respect the main economic principles: if two workers with equal length of service and equal wages during the service retire at different age, the worker who retired at younger age must receive a proportionally lower pension benefit, as the expectation is that he/she will be receiving the benefit for a longer period of time than the worker who retired at older age. That is why sustainably designed pension systems reduce the pension benefit by 6% for each year before the statutory retirement age, i.e. increase the pension benefit by 6% for each year after the statutory retirement age. To simplify, people can decide to receive EUR 200 pension over a period of 10 years, or EUR 100 pension over a period of 20 years, but the option to receive EUR 200 for 20 years must not be allowed. Graph 6.4 shows that Serbia is one of rare countries that did not introduce actuarial penalty factors at all. If it is taken into account that Serbia allows retirement a considerable number of years before the statutory retirement age as well (Graph 6.1), it can be easily concluded that the Serbian pension system is the European negative record holder in terms of the actuarial (in)equality in retiring at different age. At the same time, it is economically irrational, as it provides wrong incentives for deciding on one's length of service or time of retirement. The data for previous years suggests that one half of female old age pensioners and as much as three quarters of male old age pensioners – retire before the statutory retirement age. That is why the introduction of the actuarial penalty and reward system imposes as the priority in the coming period – to ensure the financial sustainability of the pension system and the (actuarial) equality within peer generations. The expected savings of approximately 0.1% of GDP in the first years of its implementation would be increased over time and would reach as much as 0.4% of GDP after fifteen years or so, when the full long-term effects of the actuarial equality factor system will be reached. Without introducing actuarial factors, any further increase of the statutory retirement age would be meaningless, since that would only increase the workers' incentives to retire before the statutory retirement age without any financial consequences. In addition, it is necessary to accelerate the actual dynamic for the increase of the minimum retirement age from 53 to 58 years of age.

**Graph 6.4 Percentage Pension Decrease for Each Year of Retirement before Statutory Retirement Age, in Selected Countries**




Source: World Bank (2009)

***The demographic and social circumstances in the Republic of Serbia cannot be an excuse for a considerably lower retirement age for women in relation to men – 60 years of age for women vs. 65 years of age for men***. Most developed countries equalized the retirement age for men and women in the last couple of years. However, the old practice in terms of retirement of men and women is still kept by a number of Easter European countries – primarily as a consequence of the local social circumstances and the fact that the level of social emancipation in the Eastern Europe is lagging behind the Western Europe. However, even if one takes into account the social circumstances, it is difficult to explain the retirement age for women, which is five years lower than that for men in Serbia. The relevant data shows that female old age pensioners receive pension on an average two to three years longer than male old age pensioners. In addition, the difference between the life expectancy for 65 years of age between men and women in Serbia is among the lowest in Europe – two years difference, in relation to four years difference in most Western European countries (Rakic and Chiappe, 2008). That is why, from the social aspect, it can be discussed weather it is necessary in Serbia, in the medium term, to equalize the retirement age for men and women. However, the current difference of as much as five years is unsustainable, and in the short term, it is necessary to increase gradually the retirement age for women – for example, phased increase of retirement age by six month in every calendar year, so that the final retirement age for women at the end of the six year transitional period is 63 years of age.[79] In terms of the comparable countries, Bulgaria recently adopted a similar solution, whereby men retire at 65 and women at 63 years of age, while Poland opted for a more extreme reform – the retirement age for men and women was increased in stages to 67 years of age.

***In the medium term, it is necessary to implement an adequate actuarial stabilizer system to ensure that pension system is adjusted with the demographic population aging.*** The main cause of financial problems in the pensions systems across Europe is the fact that the public PAYG pension system parameters had not been adjusted regularly with the demographic population aging in the 20th century. In most European countries, from the beginning of the 20th century, when most European countries introduced pension systems, until the beginning of the 21st century, the average life span was increased by approximately 10 years, on average, while the fertility rate for women was considerably decreased below the simple reproduction level. Most frequently, these demographic trends were not followed by the necessary and appropriate increase of retirement age, while some countries have even introduced more generous early retirement conditions over the years.[80] That is why the problems with financing at the end of the 20th and the beginning of the 21st century forced a large number of European countries to implement long deferred parametric reforms, such as increasing the retirement age, to preserve the stability and solvency of public pension systems. However, the pension system parametric adjustments are imminently unpopular social reforms that can often result in political and social challenges and instabilities. That is why it is necessary to consider the introduction of flexible legal mechanisms for the automatic adjustment of the main indicators in the Serbian pension system, and primarily the retirement age, in line with the demographic changes in the coming years and decades. Similar measures were implemented recently in a large number of European countries, including Sweden, Italy, and Greece.

[79] From the social aspect, it is possible to consider also the option of having different retirement ages for women depending on the number of children – an approach used in some Eastern European countries such as Czech Republic and Slovakia.

[80] Many countries have introduced an early retirement option as an (inadequate) response to the economic crisis and increased unemployment in 1970s (Martin and Edward Whitehouse, 2008).

***It is necessary to initiate even now a social debate about the optimum redistribution level in the public PAYG system in the coming decades.*** The current minimum to maximum pension ratio of approximately 1:8.5 suggests a relatively low redistribution within a generation.[81] Considering that the process of economic transition brought about the increased unemployment rates in the previous decade, as well as increased the problem of undeclared wages ("underground" wages) – a question can be raised from the social aspect weather an increase of the redistribution level in the pension system in the coming decades could be a partial compensation for the transition losers who were most severely affected by the worsened labor market conditions in the previous (and this) decade? The current pension system parameters, which imply the indexation of the average pension primarily in line with price inflation, and the indexation of the minimum pension in line with wage inflation, in the coming years/decades, will reduce the minimum to maximum pension ration, ensuring implicit income redistribution to the benefit of the lowest-income and lowest-pension population. Considering that the public pension system is one of the pillars of the Serbian economy and society, it is necessary to initiate a public debate even now to crystallize the social position about the optimum pension system redistribution level in the coming decades. This would allow for the expected redistribution level to be explicitly specified, to inform the young labor market participants and enable them to make their plans in relation to realistic and sustainable expectations regarding the income from the public pension system in the coming decades.

[81] A relatively low redistribution level is one of the characteristics of the Bismarck-type pension systems. A certain level of redistribution is present in the segment of the lowest and the highest pensions, which have a ratio of 1:8.5, while the minimum and maximum pension contribution base ratio is 1:14.

## 7. REFORM OF THE GOVERNMENT WAGE AND EMPLOYMENT SYSTEM

### Current trends and problems

The Serbian economy, and its private sector in particular, is not able to sustain extremely high spending on salaries of those employed in the public sector. Public sector wage bill is still on an unsustainably high level – in 2010 it was 12.6 percent of GDP, in comparison to the average of 10.1 percent of GDP in the new EU-10 member states. It is necessary for the salaries expenditure share in GDP to be decreased in the following years to a sustainable level of 9.5 percent of GDP. The main cause of such a high share of public spending on salaries in GDP is the high level of salaries in the state sector, which are for about 39.6 percent higher than in the real sector of economy. Excess of employees in certain parts of the state sector also contributes to the unsustainably high expenditure for the employees. Current legal framework for setting up salaries in public services is extremely complicated and consists of five different bases and around 600 different pay coefficients for different positions of those employed in different sectors. This causes unfairness, since some employees with the same qualifications and same job description earn significantly different salaries, even several times, in different parts of the state administration.

### Proposed measures

1. Temporary freezing of salaries, in order to adjust the level of salaries in the state sector with the productivity in the real sector and the level of salaries in the private sector.
2. Introduction of the system of grade levels (12 to 15) which would, in a systematic and consistent way, deal with the issue of the level of salaries for similar positions in different state and public services.
3. Introduction of a unified register of employees in the public sector sector, which would include all levels of state and all institutions that are financed from public revenues.
4. Systematic solution for irrationalities and excess of employees in certain state and public services, such as the excess of employees in local administration, excess of non-medical staff in health department or excess of teaching staff in elementary education. In mid-term, it is possible to reduce the current total number of 440,000 employees for about 5 percent, mostly in the sectors of education, health, local governments and public agencies.

### Expected effects

Freezing of salaries during one calendar year will accumulate fiscal savings of around 0.3 percent of GDP on the annual level. Rationalizing the number of employees in state administration and public services could provide savings of around 0.4 percent of GDP annually over the medium-term. Introducing the system of grade levels and rationalization of the number of employees in state and public services will enable a more efficient delivery of services of the public sector, whose expenditure will be in accordance with the possibilities and productivity of the Serbian economy.

***The share of public wage expenditures in Serbia in 2008 was higher than in any of the EU transition member states.*** Table 7.1 shows that wage expenditures in 2008 were

12.9% of GDP or as much as 2.8 percentage points higher than the average for the new EU-10 members.[82] The wage expenditures in Serbia are higher even than that of the old EU-15 members, which in 2008 allocated approximately 10.5% of GDP for wages.[83] Such unsustainably high public wage expenditures, as well as the overflow of the global economic crises to Serbia, resulted in the nominal wage freeze in 2009 and 2010. While this measure had some positive short-term fiscal impacts during the recession, the public wage expenditures in Serbia remained at an unsustainably high level – at 12.6% of GDP in 2010, relative to the average for the new EU-10 members of 10.1% of GDP. That is why the legal fiscal responsibility rules adopted in 2011 included a rule for the government sector wages – (maximum) allowed real wage growth limited to one half of the actual economic growth, to reduce the wage expenditures as a share of GDP in the coming years to an acceptable level of 9.5% of GDP.[84]

**Table 7.1 Government Sector Wage Expenditures as Share of GDP (%)**

| Country | 2008 | 2010 |
|---|---|---|
| **Serbia** | **12.9** | **12.1** |
| Latvia | 12.0 | 10.2 |
| Hungary | 11.5 | 10.7 |
| Estonia | 11.4 | 11.8 |
| Slovenia | 11.0 | 12.4 |
| Lithuania | 10.8 | 11.1 |
| Romania | 10.3 | 9.6 |
| Poland | 10.0 | 10.1 |
| Bulgaria | 9.2 | 9.4 |
| Slovakia | 6.9 | 7.9 |
| Czech Republic | 7.6 | 8.0 |
| EU-10 – average | 10.1 | 9.8 |

Source: Eurostat, Serbian Fiscal Council

***In 2010, the general government sector was nearly 440,000 employees strong.*** Table 7.2 shows a detailed employment composition in the general government sector, based on the information from the relevant administrative sources and employment plans. However, considering that Serbia does not have a central registry of all government sector employees, these data need to be taken with caution as there is a real possibility that they are not complete – particularly due to an increase in the number of public agencies and independent bodies in the previous period. The government sector comprises almost 100,000 employees in the central and local-level administration, almost 90,000 employees in the public security sector, almost 20,000 employees in the judiciary sector, and approximately 230,000 employees in public education, health, culture and social welfare services. Also, it has to be noted that the

[82] In accordance with international methodology, public sector wage expenditures are presented as a sum of the overall expenditures for gross wages and contributions payable by employer (so-called *gross-gross* or *gross-2* wages). In Serbia, public sector wage expenditures are still recorded only at the level of expenditures for gross wages, and do not include contributions payable by employer. In this report, the international methodology and wage expenditures is presented in *gross-gross* totals amounts, i.e. the official data regarding wage expenditures in Serbia is increased by approximately 1.8% of BDP to include social contributions payable by employer.

[83] In 2008, only the Scandinavian countries spent a higher share of GDP on public wage expenditures.

[84] In accordance with fiscal rules, the target for gross wage expenditures is 8% of GDP, which is equivalent to 9.5% of GDP including contributions payable by employer.

figure of 440,000 employees in the government sector does not include approximately 150,000 employees in public enterprises at the central and municipal levels, as these enterprises are not a part of the government sector.

**Table 7.2 Government Sector Employment Composition**

| | |
|---|---|
| Central-level Administration | 34,313 |
| Local-level Administration | 60,810 |
| Army | 36,000 |
| Police | 48,414 |
| Judiciary | 21,723 |
| Culture and Social Welfare | 7,798 |
| Education | 125,127 |
| Health | 104,599 |
| TOTAL | 438,784 |

Note: Employees in the judiciary include 4,416 employees in Administration for Enforcement of Penal Sanctions.
Source: Ministry of Finance

*Structure of Central-Level Administration Staff*

While the general public often perceives the central-level administration employment as the main source of potential downsizing and layoffs, a detailed analysis in the table below suggests that 34 thousand employees at the central administration level is actually an extremely heterogeneous group of people employed in very different areas. The item Other Central-level Administration is particularly heterogeneous, comprising over six thousand employees in independent institutions such as Anti-Corruption Agency or Supreme Audit Institution, very specialized institutions such as Serbian Statistical Office or Hydrometeorological Institute, and elected representatives in the Parliament and the Government. There is still room for downsizing at the central administration level, but that would be in the order of a couple of thousand employees rather than tens of thousands which can be heard in the general public circles.

| | Number of employees |
|---|---|
| Pension Fund Administration | 3,264 |
| Health Insurance Fund Administration | 2,420 |
| National Employment Service Administration | 1,992 |
| Republic Administration | 26,637 |
| Customs Administration | 2,842 |
| Tax Administration | 6,856 |
| Treasury Administration | 1,245 |
| Geodetic Authority | 2,670 |
| Ministry-level Employees | 6,672 |
| Other Central-level Administration | 6,352 |
| TOTAL, Central-level Administration | 34,314 |

***The unsustainably high overall government sector wage expenditures are primarily a consequence of unproportionally high wages in relation to the economic capacities, which is contributed also by the surplus employment problems in specific government***

***sectors.*** Table 7.3 shows that, Serbia is the negative record holder among the EU-10 transition members in terms of the government sector employees as a share of total (formal) employment, as well as in terms of the difference between the average wage in the government sector and the private sector – this difference in Serbia is as high as 40 percent! The fact that Serbia has a considerable level of grey economy and that the real wages in the private sector are underestimated does not change this main conclusion, as tax evasion is an issue, to a greater or lesser extent, in all the other transition economies indicated in Table 7.3.[85]

**Table 7.3 Government and Private Sector Wages and Employment Levels, 2008**

| Country | Government sector employees as a share of total employees | Average government sector wage exceeding private sector wage by |
|---|---|---|
| **Serbia** | **22.2%** | **39.6%** |
| Latvia | 20.3% | 31.9% |
| Hungary | 21.5% | 30.1% |
| Estonia | 19.1% | 24.6% |
| Slovenia | 19.1% | 27.4% |
| Lithuania | 21.4% | 28.0% |
| Poland | 19.3% | 24.9% |
| Romania | 14.0% | 20.3% |
| Bulgaria | 17.9% | 27.2% |
| Slovakia | 18.3% | 22.6% |
| Czech Republic | 19.8% | 20.3% |
| EU-10 - average | 19.1% | 25.8% |

Source: International Monetary Fund

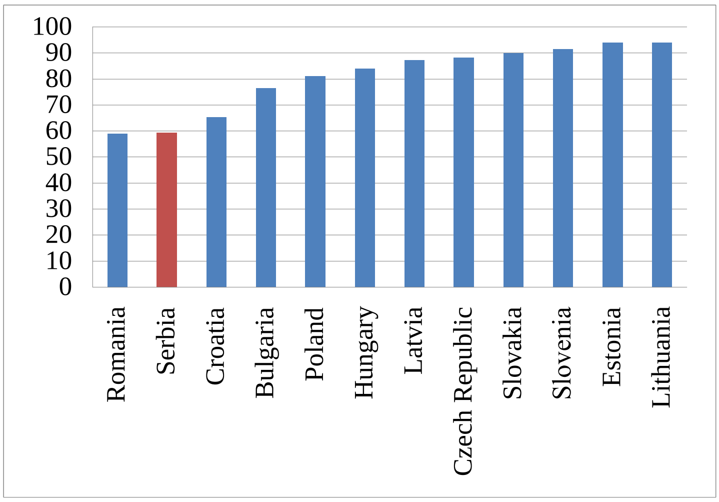
***The ratio of the government sector employees to the overall population of Serbia is among the lowest in the comparable transition economies (Graph 7.1).*** Thus, it can be concluded that the main source of the imbalance between the employee numbers in the government sector and the private sector is not the government sector overemployment, but the underemployment in the private sector. More specifically, with the employment rate below 50%, Serbia is far below the average employment rate for EU-27 of 65% and the employment rate of approximately 62% in the new EU-10 members. A particular reason for concern is the formal (non-agricultural) employment rate, which, in Serbia, is only about 35 percent. However, the conclusion that the overall government sector employment rate is not a reason for concern has to be taken with caution, for several reasons. Namely, it has already been stated that Serbia does not have comprehensive and credible data on the total number of employees in the government sector, as there is no adequate central registry.[86] That is why the figure of 440,000 employees in the government sector is based on the administrative data and employment plans that do not necessarily fully reflect the actual situation. In addition to that,

[85] In 2008, the state sector staff as a share of total employment in Serbia, in accordance with the Labor Force Survey, which included also (informally employed) farmers was only 17.1%. However, from the economic aspect, it is not adequate, in this context, to include informally employed farmers, and what is relevant is the share in the total registered employment – which was 22% in 2008.

[86] Moreover, the Serbian Statistical Office still has to define the methodology for capturing staff in the state sector in accordance with the international practice, so that the data currently available for Serbia cannot be considered internationally comparable.

this estimate does not include the employees in public agencies and independent bodies. Finally, it has to be noted that the estimated number of 440,000 employees in the government sector does not include a considerable number of persons hired under short-term contracts, without signing a formal employment contract, which is a practice that is often used by the state bodies to circumvent the limitations that apply to regular permanent employment contracts.

**Graph 7.1 Government Sector Employment per 1,000 Population**




Source: World Bank (2010)

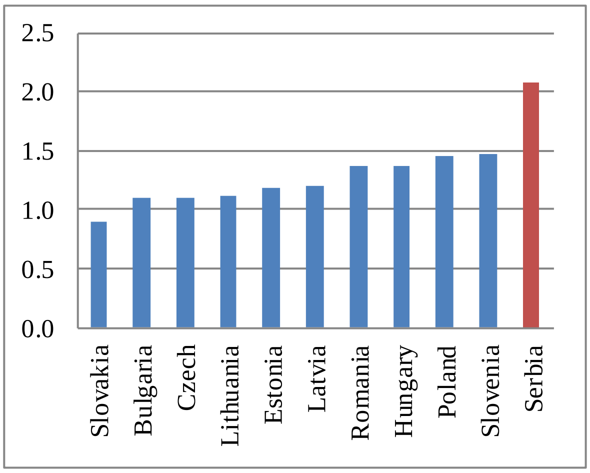
***While the overall number of employees in the government sector does not appear to be an alarming problem, more serious problems are caused by the inadequate employee allocation across various sectors in the public administration and public services.*** Thus, for example, the World Bank (2009 and 2010) identified a considerable surplus of non-medical stuff in the health sector, an unjustified increase of the local-level administration in the period between 2006 and 2008, and a large employment surplus in the (primary) education sector, due to an inadequate primary education institutional structure, particularly in rural areas, which had not been adjusted to considerably lower numbers of enrolled students in the last two decades.[87] In addition, specific sectors in Serbia, such as the tax administration or the public safety sector, are understaffed in relation to the comparable experiences from other countries. In the medium term, it is necessary to establish a more efficient and productive employment structure in the government sector, while the overall number of 440,000 employees could be reduced by approximately 5% through the implementation of carefully designed structural reforms, primarily in the education and health sectors, local government and public agencies. The above employee cuts in the public administration and public services could, in the medium term, result in the savings at the level of approximately 0.4% of GDP annually.

***The main cause of the unsustainably high public wage expenditures is the unproportionally high wages in the government sector in relation to the capacities of the***

[87] A considerable staff increase of about 10 percent in local governments is a consequence of increased funding available due to the adoption of the Law on Financing of Local Governments at the end of 2006. The legal changes from May 2011 made available to local governments additional funds that could be used in the coming period for additional local-level wage bill increase. Thus, for example, in December 2011, the Government adopted the decree on significant increase of the wage coefficients for the local government employees.

***Serbian economy.*** Graph 7.2 shows that the average wage in the government sector in Serbia is twice as high as GDP per capita, while in most other comparable countries this ratio is much more favorable.[88] In addition, in Table 7.3 it was noted that the average government sector wage was almost 40% higher than the average registered private sector wage. This wage difference between the government and private sectors is even more drastic if we were to exclude from the private sector average some 150,000 employees in public enterprises, who are also in a considerable better position than the private sector employees. Even with the previously stated issue of grey economy and underestimated real wages in the private sector, it is uncontestable that there is a large imbalance between the living standard of the government sector and the private sector employees, which is even more obvious if one takes into account that the government sector employees have various perks and benefits that the private sector employees do not have access to. Such a large imbalance cannot be justified by the fact that the government sector employees, have, on average, higher qualifications and longer work experience than the private sector employees.[89]

**Graph 7.2 Average Government Sector Wage to GDP per Capita Ratio**




Source: World Bank (2010)

***A large difference between the living standard of the government sector and the private sector employees is not only a source of fiscal problems, but also has an exceptionally negative impact on the economic growth and activity.*** Such situation creates a system of negative incentives that suffocate the private initiatives and entrepreneurial spirit, which are the main sources of sustainable economic growth and development[90]. That is even more true if one takes into account that the government sector employees, in addition to the above mentioned cash benefits, also have various other benefits that are not available in the private sector, such as job security or strict observance of the statutory employees' rights.

[88] The exceptionally unfavorable ratio in Serbia is partially a result of the above mentioned exceptionally low (formal) employment rate.

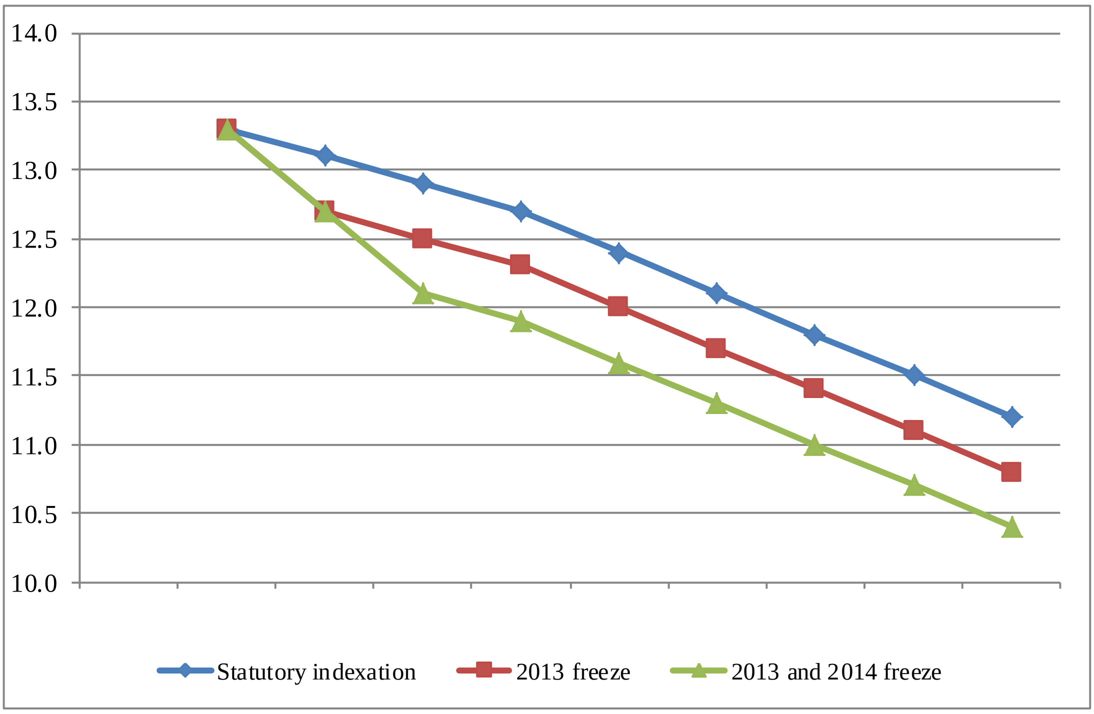
[89] Detailed analyses of the differences between the government sector and the private sector wages, taking into account the factors such as qualifications level or professional experience, are not available on a regular basis in Serbia. The preliminary analysis that was prepared in 2009 based on the data from the Labor Force Survey suggests that the average government sector wages are approximately 20% higher than that in the private sector, if various explaining factors are taken into account. Lausev (2012) shows that the advantages of government sector employment over the private sector are especially pronounced in case of less qualified workers.

[90] A great number of administrative barriers and quasi-fiscal levies is also an additional burden on the private initiative in Serbia.

That is why the fiscal and economic sustainability, but also the development imperative, and the elementary feeling of social equality, call for a phase out of the large imbalance between the government sector and the private sector wages in the coming period.

***In the short term, a nominal wage freeze needs to be considered, while in the medium term, a comprehensive reform of the employment and wage system in the government sector needs to be implemented.*** Graph 7.3 shows the potential savings that can be achieved based on the wage freeze. A wage freeze in 2013 would ensure the additional savings at the level of 0.3% of GDP annually, while a wage freeze in 2014 would ensure the additional savings of approximately 0.3% of GDP. A wage freeze in 2013 and 2014 would enable bringing the share of wage expenditures in GDP by the end of this decade closer to (without reaching) a sustainable level of 9.5% of GDP, which is specified in accordance with the fiscal rules and the Budget System Law. Depending on the intensity of the rationalization and savings in the other public expenditure segments, it is possible that the government sector wages would have to be frozen over a period of one or two years. Considering the existing significant fiscal imbalances, neither the option of one-time government sector wage cuts can be *a priori* excluded.

**Graph 7.3 Wage Expenditure Projections (% of GDP)**




Source: Fiscal Council

***The period in which the nominal wages would be frozen needs to be used to improve the legal regulations and operative procedures to enable the implementation of adequate, efficient, and long-term sustainable employment structure in the government sector.*** The Law on Civil Servant and Employee Wages adopted in 2005 established a consistent framework for the central level administration wages, based on a uniform nominal wage base and a range of 13 coefficients. However, this Law does not apply to the employees in public agencies and local governments, and that is why it is necessary, in the coming period, to extend the coverage of this Law to include these public administration segments as well. In addition, the issue of the military and police sector wages needs to be solved.

***There is a need for major improvements of the legal regulations in the segment of wages in public services – education, health, culture, and social welfare.*** The current legal framework for determining wages in public services in extremely complicated and specifies five different bases and approximately 600 different coefficients for different posts in various sectors (World Bank, 2010). Such a complicated system results in a large number of inconsistencies and inequalities, as it opens rooms for employees with identical qualifications and identical job descriptions to earn considerably higher and even several times multiplied wages in different parts of the general government for a comparable performance. This issue is further aggravated by the fact that the wage bases and coefficients for public services are not stipulated at the level of a law, but under a Government Decree – which leaves a possibility for more influential trade unions to bargain for unrealistic benefits for the employees in specific sectors, which in turn causes a domino effect and dissatisfaction of all other employees in the government sector. The World Bank (2010) recommends that a uniform base for the employees in public services and 12–15 pay grades should be introduced to solve in a consistent and sustainable manner the issue of the wage levels for similar or identical posts in different parts of the government sector.

***From the operative point of view, there is a need to develop a comprehensive central registry of all employees in government and public services to ensure adequate and consistent enforcement of legal regulations.*** The registry of employees in the central level administration and education, maintained by the Treasury Administration, has been maintained successfully for years. However, this registry covers only about 150,000 of the total of 440,000 employees in the public administration and public services. That is why it is necessary to extend the coverage of the existing information system to include the employees in the remaining parts of government sector – health, police, army, public agencies. The central registry concept has been implemented successfully in many developed countries, and among the countries in the region, Croatia is currently at the stage of developing the adequate information system. Only a modern information system and adequate database can enable adequate monitoring of the employment structure in the government and public services, and ensure the consistent enforcement of legal provisions and the restricted use of budget funds. The implementation of the central registry would also enable the rationalization of considerable expenditures of hiring temporary and short-term staff, as well as hiring consultants under service contracts.

# 8. REFORM OF STATE- AND SOCIALLY-OWNED ENTERPRISES

**Recent Developments and Issues**

After ten years of transition, Serbia still has about 1.300 state-controlled enterprises (state-owned and socially-owned enterprises). A high share of state-controlled enterprises in GDP, social wealth and employment has a negative impact on economic efficiency, encourages financial noncompliance, corruption, etc. In 2010, the overall losses of the state-owned, socially-owned and public enterprises were approximately one billion EUR (approximately 3.5 percent of GDP). The enterprises assigned to the Privatization Agency use considerable resources (they employ 5 percent of employees in Serbia and have approximately EUR 5 billion of social wealth committed), while their performance is exceptionally poor (they generate 1.5 percent of GDP, annual losses at the level of EUR 400 million, and liabilities towards the state and public enterprises of approximately EUR 1.5 billion). From the fiscal point of view, what is relevant is that the state-controlled enterprises receive direct budget subsidies, which contributes to the increasing public spending and fiscal deficit. In addition to that, these enterprises receive various forms of indirect subsidies such as government guarantees for loans, tax holidays, “linking of the years of service”, which increases the current and future public expenditures and reduces public revenues. The overall government expenditures for assistance to these enterprises (direct subsidies, service buyoff transfers and guaranteed loans for cost servicing) were approximately 2.7 percent of GDP in 2010, approximately 2.3 percent of GDP in 2011.

**Proposed Measures**

1. Establish a limited period of approximately two years to solve the status of the enterprises assigned to the Agency, including the enterprises undergoing restructuring, their privatization or initiation of bankruptcy procedure.
2. Establish strict budget ceilings through the efficient enforcement of the bankruptcy procedure, shortening payment timelines, etc., as well as through phasing out subsidies for enterprises subject to privatization.
3. Provide funds for social programs for the employees to be laid off in the course of privatization or bankruptcy. A large portion of these funds could be ensured from the savings on subventions.
4. In case of large enterprises, undertake measure in the course of restructuring to improve their management and increase their prospects for privatization.
5. Improve corporate governance and depoliticization of the public and other enterprises in state ownership.
6. Privatize state-owned enterprises that operate or are able to operate in competitive conditions (Telecom Serbia, Galenika, Smederevo Steel Mill, Srbijagas-owned enterprises, etc.) and parts of Serbian Power Enterprise EPS.
7. Increase the prices of the public enterprise products to cost-recovery levels (electricity, gas, heating, etc.).
8. Effective liberalization of the activities performed by public enterprises, which do not have a character of natural monopolies (power generation, rail transport, some utility activities).

**Expected Effects**

Expected fiscal impacts: reduced direct and indirect subsidies to enterprises, including a reduced number of issued and called guarantees, improved tax collection, generated privatization proceeds reducing directly or indirectly public debt. The direct budgetary and extra-budgetary savings on the subsidies to state-controlled enterprises in 2013 could be 0.3 percent GDP, while in the medium term (2014–2016) they could reach 0.7 to 0.9 percent of GDP.
Expected economic impacts: increased efficiency of the overall economy, improved quality of public enterprise services, economic activity and employment growth, enforced financial compliance and reduced corruption.

Notwithstanding significant progress that was made in the last decade in the area of privatization of socially-owned enterprises and restructuring of public enterprises, the situation in this area is still unsatisfactory. A large number of socially-owned enterprises still have not been privatized, while the restructuring of public enterprises has yet to be finalized. Without dwelling on the economic and legal differences between state-owned (public and others) and socially-owned enterprises, their shared characteristic is that they are under direct or indirect government control. The share of the state-controlled enterprises in GDP in Serbia is very high, which has a negative impact on the economic efficiency, encourages financial noncompliance, corruption, etc. In 2010, the overall losses of the state-owned, socially-owned and public enterprises were approximately one billion EUR (approximately 3.5 percent of GDP). The enterprises assigned to the Privatization Agency use considerable resources (they employ 5 percent of employees in Serbia and have approximately EUR 5 billion of social wealth committed), while their performance is exceptionally poor (they generate 1.5 percent of GDP, annual losses at the level of EUR 400 million, and liabilities towards the government and public enterprises of approximately EUR 1.5 billion). From the fiscal point of view, what is relevant is that the state-controlled enterprises receive considerable direct budget subsidies, which contributes to the increased public spending and fiscal deficit. In addition to that, these enterprises receive various forms of indirect subsidies such as government guarantees for loans, tax holidays, “linking of the years of service”, which increases the current and future public expenditures and reduces public revenues. The overall government expenditures for assistance to these enterprises (including direct subsidies, service buyoff transfers and guaranteed loans servicing costs) were approximately 2.7 percent of GDP in 2010, approximately 2.3 percent of GDP in 2011. That is why the restructuring and privatization of the state-controlled enterprises is crucial, not only for the improvement of economic efficiency, but also for a successful fiscal consolidation. From the fiscal point of view, what is relevant is that the privatization of the state-controlled enterprises presents an opportunity for a direct or indirect reduction of public debt, but also for the tax revenue increase in the future.

### 8.1. Current Situation

***As a part of transition to market economy, which was initiated at the beginning of the 21st century, Serbia implemented a wide range of structural reforms, including also an ambitious program for privatization of socially-owned enterprises.*** The result was almost 2.500 enterprises privatized and approximately EUR 2.6 billion collected in privatization proceeds. While significant results had been achieved especially in the initial period, in the recent years, the reform momentum has slowed down. From 2002 to 2008, the average was 320 enterprises privatized annually, while from 2009 to 2011, the average was only 47 enterprises privatized annually. This slow down results primarily from two factors: firstly, the remaining socially-owned enterprises are relatively problematic, and secondly, there has been a decline of interest by the investors. In addition to the privatization slow down, in the recent years, the process of assisting unsuccessfully privatized enterprises has also been evident.

Parallel with the privatization of socially-owned enterprises, a large number of measures for restructuring of public enterprises have been implemented. The most important measures include: price adjustments in line with costs, reducing over-employment, unbundling non-core activities, unbundling vertically integrated monopolies (division of EPS into EPS and EMS). In most public enterprises, significant investments in equipment and infrastructure have been made (important exceptions are Serbian Railways and JAT), which improved the quality and reliability of their services. In some sectors in which public enterprises are operating effective liberalization has been implemented (telecommunications, air transport, the greatest part of postal services, oil production and distribution, gas distribution, etc.), while in other areas (electricity generation), until now, there has only been formal liberalization.

The privatization of public enterprises is at the initial stage (the most important case in NIS) and it is considered that the opportunity to privatize public enterprises that are able to operate under competitive conditions at relatively favorable prices was missed in the pre-crisis period. Moreover, as a result of the economic crisis and inadequate management, the government took over the controlling stake in some industrial enterprises either directly (Smederevo Steel Mill, Galenika) or indirectly, through Srbijagas. The takeover of the above enterprises was to a greatest extent extorted, in order to prevent their bankruptcy, which would most likely end up in their liquidation. While it may not be macro-economically significant, it is considered that the policy of establishing new public enterprises in commercial sectors (Skiing Resorts of Serbia) is economically unjustified.

**Graph 8.1 Structure of State-controlled enterprises in Serbia, 2010**

| Public Sector in Serbia | | Description | Number of Enterprises | Number of Employees |
|---|---|---|---|---|
| Privatization Agency Portfolio | | Enterprises assigned to the Privatization Agency to be resolved. | ≈ 640 | ≈ 97,000 |
| Central-level SOEs | Commercial SOEs | Enterprises operating in competitive industries (e.g. mining, pharmaceuticals, tourism, etc.) | ≈ 40 | ≈ 33,000 |
| | Public Utilities | Utility companies operating in regulated markets under (mostly) monopolistic conditions or providing public infrastructure services. | ≈ 10 | ≈ 80,000 |
| Municipal Enterprises | | Enterprises reporting to local authorities. This portfolio includes municipal utilities, enterprises operating in commercial sectors, and those that provide public goods that are non-revenue generating. | ≈ 650 | ≈ 70,000 |
| | | Total: | ≈ 1.340 Enterprises | ≈ 280,000 Employees |

***In spite of the progress that was achieved, the government influence in the enterprise sector is still quite evident.*** The current portfolio of state-controlled enterprises includes approximately 1,300 enterprises, which employ over 280,000 workers (approximately 16 percent of the total number of formally employed workers in Serbia). These 1.300 enterprises could be divided into three groups: 1) enterprises assigned to the Privatization Agency, 2) a group of state-owned enterprises comprising central-level public enterprises (e.g. EPS), and enterprises operating in commercial sectors (e.g. Galenika), and 3) municipal public enterprises (Graph 8.1).

### *8.1.1. Enterprises Assigned to Privatization Agency*

***The Privatization Agency currently has some 600 enterprises assigned to it to be resolved, which employ approximately 100,000 workers.*** The Agency portfolio is heterogeneous: it includes very large enterprises (with over 1,000 employees), about 60 enterprises with 250-1,000 employees, but also some 90 companies without any employees (most of these are in the liquidation process), and more than 130 enterprises with 1-10 employees. These enterprises have very different backgrounds as well: some of them underwent restructuring in the last ten years, and usually went through several unsuccessful privatization attempts, while others were assigned back to the Agency after the termination of the privatization agreement, and the third group includes relatively small socially-owned enterprises that also went through a number of unsuccessful privatization attempts. The Agency portfolio includes also a number of enterprises whose final status resolution is suspended due to legal problems (e.g. enterprises connected to former Yugoslav republics or Kosovo) or unclear division of competences between various levels of (e.g. local media enterprises).

***The enterprises assigned to PA generate huge losses (the overall losses reach approximately 1.5 percent of GDP annually) and accumulate considerable arrears.*** In 2010,[91] more than 500 enterprises from the PA portfolio operated at a loss. In the previous three years, the average portfolio losses were nearly as much as EUR 400 million annually. A great majority of these companies survive only due to the government support in a form of direct and indirect subsidies.

The enterprises from the PA portfolio survive primarily due to “indirect subsidies” by the government, but the assistance through direct subsidies is not negligible either. The “indirect subsidies” include approving tax and contribution holidays (e.g. in 2011 only, the arrears of the PA portfolio enterprises for unpaid tax and contributions went up by approximately RSD 15 billion), as well as tolerating non-payment of liabilities towards other public and socially-owned enterprises. As a result of that, the PA portfolio enterprises accumulated huge arrears for unpaid liabilities towards the government and public enterprises. It is estimated that the overall debt of these enterprises for unpaid liabilities towards the government and public enterprises (including municipal enterprises) as of the end of 2011 was more than EUR 1.5 billion (approximately 5 percent of GDP). Another particular and very important subsidy for these enterprises is the so-called linking of the years of service (See Box). In addition to that, these enterprises receive subsidies through the Development Fund, averaging more than EUR 90 million annually in 2010 and 2011 (this includes subsidies from the Serbian budget that the enterprises receive through the Development Fund, subsidies from the Development Fund replacement funds – mostly collections under leasing agreements, and earmarked funds administered from the ministry appropriation through the Development Fund).

[91] The last year for which complete data is available; 2011 data should be available in the next couple of months.

*Linking Years of Service*

Linking of the years of service is an atypical indirect subsidy whose beneficiaries are mostly the workers employed in the enterprises assigned to the Privatization Agency. In 2010 and 2011, this subsidy totaled approximately EUR 360 million. In the year in which the above subsidy is paid, there is no impact on the increase of public revenues or fiscal deficit, as one portion of the transfer for the Pension Fund, earmarked for the disbursement of current pension benefits, is declared the payment from the Serbian budget for linking the years of service for the workers to whom their enterprises failed to pay pension contributions in the past. On the surface, linking of the years of service appears to be an accounting operation without any incremental costs. However, the service buyoffs increase the implicit government obligations for future pension benefits. The number of years of service is directly proportional to the level of the pension replacement level, and the service buyoffs increase the government obligations towards the workers – future pension beneficiaries. That is why the term "linking the years of service" is a euphemism for the increase in the implicit government debt towards future pensioners.

***The PA portfolio enterprises accumulate also considerable arrears towards private suppliers, and they are often the main generator of illiquidity in the enterprise chains.*** Based on incomplete data**,** it is estimated that the overall arrears towards private suppliers as of the end of 2011 were almost a half of a billion EUR.

The PA portfolio enterprises control considerable resources, preventing their reallocation for more productive purposes. The book value of the PA portfolio enterprise assets is more than EUR 5 billion. Even though the reliability of this information is under a question mark, it is a fact that some of these enterprises control very valuable resources, especially land and real-estate. Resolving the fate of these enterprises would enable for the above resources to be put to a much more productive use.

***Even though they receive considerable government assistance and employ a large number of workers, the PA portfolio enterprises have a very modest contribution to the overall Serbian economy.*** These enterprises employ approximately 5 percent of the total number of formally registered employees in Serbia. However, their gross value added is less than 1.5 percent of Serbia's GDP. Their productivity[92] is very low, and is estimated at approximately 4 thousand EUR per worker, or less than one third of the average productivity in the company sector in Serbia.

***A particular problem is the "restructuring" status, which is used to permanently protect some of the most problematic enterprises from bankruptcy.*** Approximately 170 PA portfolio enterprises are in the "restructuring" status for undefined period to avoid the politically sensitive process for resolving their status. Most large enterprises assigned to the Agency could not survive in the market in their current state, and would require intensive restructuring or bankruptcy or liquidation. However, resolving the status of these enterprises requires political commitment, considering that it would imply layoffs and the opposition by the company management and some politicians.

[92] Defined as gross value added per worker.

*8.1.2. Central-Government Public Enterprises and Other State-Owned Enterprises*

***The portfolio of central-government public enterprises and other enterprises with the government controlling stake includes approximately 50 enterprises; some of them are among the largest companies in Serbia and have an important role in the overall economy.***[93] This portfolio, which includes approximately 50 enterprises[94], can be divided roughly into two groups: 1) enterprises operating in commercial competitive sectors (e.g. pharmaceutical industry, tourism), and 2) large public enterprises operating in the in regulated markets under (mostly) monopolistic conditions or providing public infrastructure services (e.g. electrical power, gas, transport). The fifteen largest enterprises from this portfolio are the most important ones in terms of the number of employees and the overall contribution to the economy: these 15 enterprises include eight public enterprises and seven enterprises operating in commercial sectors. Together, these 15 enterprises employ approximately 113,000 workers (approximately 6.5 percent of the total number of formally registered employees in Serbia). Ten of these enterprises are among the Serbia's top 20 enterprises in terms of the overall revenue, and the picture in terms of the overall assets is similar.

***The eight largest public enterprises are particularly significant for the competitiveness of the overall Serbian economy, as they provide the key inputs for all other enterprises in the country.*** The challenge for the Government is to find the right balance between numerous and often mutually conflicting objectives when it comes to the management of these companies. As the owner, the Government has to ensure that these enterprises operate efficiently, and implement the investment policy that would insure their long-term sustainability. As the regulator, it has to ensure that the tariffs enable efficient and long-term operations, but also to protect the consumers from any prospective abuse of monopoly powers.

***Large public enterprises have poor performance, inadequate incentives to improve their and are under pressure to keep the prices of services at socially acceptable levels; as a result of that, investments are low and the long-term sustainability of some of these enterprises in undermined.*** Performance measuring implies that adequate indicators need to be developed. For example, in accordance with a recent World Bank report [95], Serbia Rail productivity is only 29 percent of the EU average (in relation to 58 percent of the EU average in Croatia and 69 percent in Poland), and in 2008 only 54 percent of freight cars and 28 percent of passenger cars were in operation. A good example of an enterprise in which striving to achieve social goals (in terms of both the tariff and employment targets) leads to underinvestment problems is EPS. In accordance with a World Bank report[96], this enterprise has major underinvestment problems and Serbia faces a potential power supply crisis. More than a half (53 percent) of EPS generation plants is more than 30 years old; less than a quarter of transmission lines and substations are in good condition; distribution losses (due to dilapidated distribution network, faulty meters and thefts) currently reach 15.8 percent of gross power consumption (in relation to 5.6 percent n Czech Republic and 5.2 percent in Slovakia).

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[93] The government also has a minority stake in a number of enterprises; the largest of those enterprises are NIS and FIAT Automobiles Serbia.

[94] The Government does not have a comprehensive and integrated list of companies with majority state ownership. The Ministry of Finance monitors 29 public enterprises that have not been corporatized, and the remaining state-owned enterprises report to the line ministries.

[95] *Railway Reform in South East Europe and Turkey: On the Right Track?*, World Bank (2011).

[96] *Republic of Serbia Country Economic Memorandum*, World Bank (2011).

***To mitigate the effects of their poor performance, public and state-owned enterprises receive considerable government assistance.*** In 2011, seven out of the twelve largest public and state-owned enterprises generated losses at the level of EUR 343 million. To be able to continue to operate in spite of such losses, the enterprises receive various forms of government assistance. Direct subsidies are limited to two enterprises, Serbian Railways and PEU Resavica (in the previous three years, 2009–2011, the direct subsidies totaled EUR 378 million for Serbian Railways and 57 EUR million for PEU Resavica). However, in the last couple of years, a very frequent form of support to public companies has been issuing government guarantees for their borrowing. By the end of 2011, the overall debt of public enterprises with government guarantees exceeded EUR 1.7 billion. Chapter 3 provides a detailed discussion regarding the guarantee problem. In addition to that, the government assistance for some enterprises includes debt servicing (for these purposes, the government spent EUR 69 million in 2010 and EUR 83 million in 2011), as well as tolerating arrears for specific liabilities towards the government and other public enterprises.

***The causes for such poor economic and financial performance of public enterprises are manifold: low prices, over-employment, neglected and dilapidated equipment and infrastructure, as well as poor management in public enterprises.*** This report focuses especially on the analysis of the main indicators of poor management in public enterprises, as an important inefficiency factor, which has not been analyzed yet in detail. Most measures for improvement of the management in public enterprises are not as resource-intensive as the infrastructure modernization and development, and do not have such high social costs as layoffs or price inflation. However, improving the management in public enterprises would result in the loss of personal and political party rents and the reduction of irregular employment (political affiliations, family contacts, etc.). For the improvement of the management in public enterprises to be successful, it is necessary to undertake measures to neutralize such illegitimate interests. Some of the key indicators of inefficient management in public enterprises include:

- Limited transparency in the disclosure of performance results, especially in terms of operating indicators, targets and outcomes. Reporting on operating performance indicators is limited to annual business plans, which are not publicly available (operating plans include some operating indicators and objectives, but little or no attention is given to the actual performance evaluation).
- Even though public and state-owned enterprises have different legal statuses (e.g. some are organized as public enterprises subject to the *Law on Public Enterprises and Performing Activities of General Interest*, while some are corporatized and subject to the *Law on Business Companies*) and market structures, all of these enterprises suffer from corporate governance and financial management weaknesses.
- The management appointment process in public and state-owned enterprises is very politicized. Nominally, the Government appoints the board members and directors in these enterprises, but in reality, this depends to the greatest extent on the mutual agreements between the political parties.
- Politicization is linked to the decision-making process in which the priorities are set based on political goals (e.g. maximization of employee numbers and relatively high wage levels, as well as maintaining low tariffs as a “social” category).
- Even though the Ministry of Finance supervises the operating plans and financial reports of public enterprises, this supervision focuses mostly on the compliance with financial guidelines, rather than the quality of the strategic planning and their current management.

- It has been estimated that some of the large enterprises operating in commercial sectors have good prospects for privatization. The companies such as Telecom, Serbian Skiing Resorts, etc. could be good candidates for privatization. For enterprises in which the government decides to keep the majority stake in the medium term, the priority should be to increase efficiency through an adequate regulatory policy.

***In addition to inefficient management and inefficiencies on the cost side (staff surplus, relatively high wages, inefficient public procurements, etc.), in some public enterprises at the central level low prices of services are an important cause of their losses.*** This is especially important in the case of EPS and Srbijagas whose products are sold at prices that are below cost recovery. In addition to causing the losses of the above enterprises, low electricity and gas prices increase the probability that they will not be able to repay their debts that are guaranteed by government guarantees in the future**.**

The central-government public enterprises, but also the municipal public enterprises, have problems with the collection for their services from other enterprises and individuals. The largest liabilities towards public enterprises, and most likely uncollectible, are those of the enterprises in restructuring that are assigned to the Privatization Agency.

The legal or informal obstacles for investments in the sectors in which public enterprises operate, as well as the general unfavorable business climate prevent or obstruct the inflow of private capital in the activities performed by public enterprises. In respect to electricity power generation, low prices discourage commercial investors to invest in the construction of private thermal and hydroelectric power plants.

### *8.1.3. Municipal Public Enterprises*

Municipal public enterprises are a heterogeneous group of enterprises of different sizes and market conditions (some of them operate in sectors that present natural monopolies, while others perform activities that are open for competition).

***Currently there are approximately 645 municipal enterprises founded by municipalities or cities in operation, and they employ approximately 70,000 employees***. Most of these (348) are municipal utility companies, some of which provide their services as natural monopolies, including water-supply and sanitation companies and waste management companies. In addition to those, a large number of municipal enterprises provide commercial services, such as parking services, green market maintenance enterprises, cemetery maintenance enterprises, etc. The final group of enterprises includes those providing non-commercial services such as enterprises for park maintenance, street maintenance, licensing, etc. However, the most important group is the municipal utility companies, which employ approximately 80 percent of the total number of employees in municipal enterprises.

- The problems in the operation of public enterprises are similar to those that obstruct the operations of the central-level public enterprises:
- Their efficiency, which is on average low, varies considerably from one local government to another;
- Low prices of some utility services (heating in many local governments, public transportation in Belgrade, etc.) directly cause the losses of utility companies and the increase of the budget subsidies;
- At the aggregate level, municipal enterprises generate huge losses and receive considerable subsidies. In 2010 and 2011, municipal enterprises received approximately EUR 225 million annually (approximately 0.7 percent of GDP) in direct subsidies by local governments;

- The inefficiencies in the management of municipal enterprises have similar forms and causes as that at the central level, while the level of inefficiencies varies from one local government to another.

### 8.2. Direct and Indirect Subsidies to State-Owned and Socially-Owned Enterprises

***Most state-owned and socially-owned enterprises have poor performance, in spite of considerable assistance received by the state***. In 2010[97] , the overall losses of all state-owned, socially-owned and public enterprises were approximately one billion EUR (approximately 3.5 percent of GDP). Most enterprises that generate huge losses survive due to the support by the government through direct and indirect subsidies. The overall cash expenditures by the government for the support to these enterprises (including direct subsidies, service buyoff transfers, and costs of servicing guaranteed debt) were approximately 2.7 percent of GDP in 2010 and approximately 2.3 percent of GDP in 2011. In addition to being excessive, these expenditures are often non-transparent and are not based on cost-benefit impact assessments. In addition to these direct expenditures, the enterprises receive also a very sizable support in a form of indirect subsidies: tolerating accumulating arrears for tax and contributions and unsettled liabilities towards public enterprises, as well as government guarantees for debt. By the end of 2011, the overall accumulated arrears for unsettled liabilities and issued government guarantees exceeded 12 percent of GDP, of which the guarantees issued for company debt were approximately 6 percent of GDP, accumulated arrears for unsettled liabilities towards the government were approximately 4.5 percent of GDP, and the arrears towards public enterprises were approximately 1.7 percent of GDP. The various forms of government assistance provided to these enterprises are summarized in Tables 8.1.a and 8.1.b.

**Table 8.1a Subsidies to State-Controlled Enterprises (percent of GDP)**

| | “Cash“ Expenses (2010 and 2011 average) | | | |
|---|---|---|---|---|
| | Direct Subsidies | Guaranteed Debt Servicing Expenditures | Service Buyoff Transfers | **Total** |
| Privatization Agency Portfolio | 0.3* | 0.0 | 0.5 | **0.7** |
| Public and Large State-owned Enterprises | 0.5 | 0.3 | 0.1 | **0.8** |
| Municipal Enterprises | 0.8 | 0.0 | .. | **0.8** |
| **Total** | **1.6** | **0.3** | **0.6** | **2.5** |
| | “Cash“ Expenses (2010 and 2011 average) | | | |
| | Stock of Issued Government Guarantees | Accumulated Arrears towards Government (Tax, Contributions, etc.) | Accumulated Arrears towards Public Enterprises | **Total** |
| Privatization Agency Portfolio | 0.2 | 3.6 | 1.5 | **5.3** |
| Public and Large State-Owned Enterprises | 5.7 | 0.9 | 0.3 | **7.0** |
| Municipal Enterprises | 0.0 | .. | .. | **..** |
| Total | **5.9** | **4.6** | **1.7** | **12.2** |

Source: Ministry of Finance, Privatization Agency, Fiscal council

[97] The last year for which there are complete set of data; the 2011 data are supposed to be available in the following few months.

**Table 8.1b Subsidies to State-Controlled Enterprises (in Million EUR)**

| | “Cash“ Expenses (2010 and 2011 average) | | | |
|---|---|---|---|---|
| | Direct Subsidies | Guaranteed Debt Servicing Expenditures | Service Buyoff Transfers | **Total** |
| Privatization Agency Portfolio | 94* | 0 | 172 | **266** |
| Public and Large State-owned Enterprises | 160 | 76 | 12 | **248** |
| Municipal Enterprises | 223 | 0 | .. | **223** |
| **Total** | **477** | **76** | **184** | **730** |
| | “Cash“ Expenses (2010 and 2011 average) | | | |
| | Stock of Issued Government Guarantees | Accumulated Arrears towards Government (Tax, Contributions, etc.) | Accumulated Arrears towards Public Enterprises | **Total** |
| Privatization Agency Portfolio | 74 | 1.100 | 441 | **1.616** |
| Public and Large State-Owned Enterprises | 1.742 | 288 | 84 | **2.113** |
| Municipal Enterprises | 0 | .. | .. | **..** |
| Total | **1.816** | **1.388** | **525** | **3.729** |

* Includes Serbian budget subsidies provided to these enterprises through the Development Fund, subsidies from the Development Fund replacement funds (mostly collection under leasing agreements), and earmarked funds administered from the ministry appropriation through the Development Fund.

Note: The data on direct subsidies, service buyoff transfers, and the stock of government guarantees are the original data provided by the Ministry of Finance and the Development Fund. The data on accumulated arrears towards the government and towards public companies are estimates based on the incomplete data provided by the Ministry of Finance and the Privatization Agency.

Source: Ministry of Finance, Privatization Agency, Fiscal council

***For the enterprises assigned to the Privatization Agency, the main form of support is direct subsidies, including primarily tolerance of non-payments of taxes and contributions and tolerated arrears for liabilities towards the state and public enterprises***. Most enterprises assigned to the Agency operate at a loss; on average, the overall losses from 2008 to 2010 were 350 to EUR 400 million annually. In order to survive in spite of such losses, the enterprises assigned to the Agency are approved by the state tax and contribution holidays and arrears for liabilities towards public enterprises. In addition to that, the enterprises assigned to the Agency receive support through direct subsidies, mostly through the Development Fund.

***Another important form of support to the enterprises assigned to the Privatization Agency is the service buyoff transfers***. The overall amount of service buyoff transfers by the Ministry of Finance was EUR 248 million in 2010 (approximately 0.9 percent of GDP) and EUR 121 million in 2011 (approximately 0.4 percent of GDP). Not only are these transfers financially significant, another problem about them is that, due to these transfers, the employees in the enterprises assigned to the Privatization Agency have a preferential treatment in relation to the employees in the private companies that are in financial difficulties (if the employers of the employees in private companies fail to pay the contributions to the Pension Fund, their employees cannot enjoy the right to pension, and then cannot count on the government to link their years of service). Additionally, these transfers defer and complicate the resolution of the status of non-privatized enterprises, as, due to them, the employees have a strong incentive not to leave those enterprises, in order to continue to enjoy their pension rights.

***For public and large state-owned enterprises, the main forms of support are direct subsidies (even if they are provided to only two enterprises) and, in the last couple of years, issuing government guarantees for borrowing.*** As it has already been stated, Serbian Rail and PEU Resavica receive direct subsidies by the state, totaling from 2009 to 2011 EUR 378 million for Serbian Railways, i.e. EUR 57 million for PEU Resavica. In the last couple of years, there has been a rapid expansion of issuing government guarantees. By the end of 2011, the overall issued guarantees to public companies exceeded EUR 1.7 billion. Chapter 3 provides a detailed discussion of the guarantee problem. In addition to the above, the government assistance for some enterprises includes debt servicing. For these purposes, in 2010 and 2011, the government spent over EUR 150 million in total. Finally, the government support reflects in tolerating arrears and non-payment of specific liabilities towards the state and other public enterprises. At the end of 2011, the accumulated arrears of public enterprises for unsettled liabilities towards the state and other public enterprises were estimated at approximately EUR 360 million, i.e. over 1.2 percent of GDP[98] (the largest portion of these accumulated arrears refers to the liabilities of Serbia Rail).

## 8.3. Reform of State-Controlled Enterprises

### *8.3.1. Reform of Enterprises Assigned to Privatization Agency*

***The main objective of the reform of the enterprises in this sector is to complete the privatization process during the mandate of the new Government.*** After more than a decade from the beginning of transition, there are no more credible reasons for deferring the privatization of the enterprises that remained with the Agency.

This objective can be achieved through the implementation of the following measures:

- Specify the timeframe for the privatization of enterprises or, if that is not possible, the initiation of bankruptcy. To improve their prospects for privatization it is possible to write off their old debts, after which firm budget ceilings need to be introduced. If the enterprises would continue to accumulate arrears, bankruptcy procedure would be initiated even before the expiry of the timeframe for privatization.
- Revise the decree on restructuring[99] to limit the duration of the enterprise restructuring procedure to maximum two years. During this period, the enterprises would be privatized or, if that is not possible, their bankruptcy would be initiated.
- In terms of the enterprises in restructuring, measures would be taken to improve of their management, similar to the measures proposed for public enterprises, to increase their prospects for privatization.
- To maintain social stability, it is necessary to provide additional funds for social programs for the workers to be laid off in the privatization process. The financial requirement for that purpose is estimated at a couple of hundreds of millions of EUR (probably between 300 and 500 millions), which is comparable to the amount transferred for service buyoffs and direct budget subsidies received by these enterprises in a period of two years. The costs could be even lower if decisive reforms to improve business environment and attract investments, which would at least partially absorb the redundant workers in the enterprises assigned to the Privatization Agency, would be implemented immediately.

[98] On the other side, public enterprises have even higher unsettled liabilities, at approximately 1.9 billion euros. Approximately one half of those liabilities relates to other socially-owned and state-owned enterprises, approximately one quarter to private companies, and approximately one quarter to individuals.

[99] Decree on the Procedure and Manner of Restructuring Entities Undergoing Privatization, Government of the Republic of Serbia.

*8.3.2. Reform of Central-Government Public Enterprises*

***From the aspect of public finance, the main objective of the reform of public enterprises is the reduction of direct and indirect subsidies to public enterprises.*** Direct subsidies to public enterprises would probably not be significantly reduced at the central level, but the same level of subsidies would ensure more efficient service delivery.[100] However, the indirect subsidies (guarantees, linking of the years of service, tax arrears, etc.) could be significantly reduced. In addition to that, the privatization of some public enterprises could ensure considerable proceeds that could be used for a direct (repayment of the existing debts) or indirect reduction of public debt (financing of reduced future fiscal deficit by privatization proceeds). From the aspect of public finance, the privatization of public enterprises is desirable even if it does not result in budget inflows.

From the economic point of view, the objective of restructuring is the improvement of the efficiency of public enterprises, which can be achieved through the implementation of the following measures:

- Improving corporate governance; the Government needs to complete the corporatization of the remaining large public enterprises.
- To achieve the expected benefits of corporatization, it is necessary to establish and implement a transparent and professional framework for appointment of directors and managing and supervising board members in public enterprises.
- For large public enterprises, it is necessary to strengthen the role of the government as the owner, including the manner in which it manages public enterprises and supervises their performance. One possible approach to this is a clear delegation of duties and responsibilities to a specialized department within the Ministry of Finance, which could help to reduce unfavorable political influences and ensure more focused and efficient capacity strengthening.
- An important element of the reform of public enterprises needs to be a development of an integrated performance management system, including a development of "key performance indicators". The actual performance information would be disclosed to the public. There is a need also to introduce strict budget ceilings (i.e. prevent the accumulation of unsettled liabilities and unjustified issuance of guarantees).
- The system of subsidies, guarantee issuance, but also the tariff setting and the appointment of management need to be reformed gradually so that they are based on the actual operating performance of the enterprises, measured based on both financial indicators and the "key performance indicators".
- The current government assistance system is fragmented; there is a need to develop an integrated and comprehensive database for all forms of government assistance, which would include public and large state-owned enterprises, the enterprises assigned to the Privatization Agency and municipal public enterprises.

***The improvement of the management in public and industrial enterprises (Galenika and others) in direct or indirect ownership of the government would increase their privatization prospects.*** From the aspect of economic efficiency, the privatization of the enterprises operating in competitive conditions, such as Telecom, Galenika, Smederevo Steel

[100] The largest portion of direct subsidies is currently directed to the rail sector, which could be expected also in the future. However, the restructuring of the rail sector should ensure that the subsidies are used for infrastructure maintenance and modernization, rather than for employee wages.

Mill, enterprises in the ownership of Srbijagas, Serbian Skiing Resorts, etc. is justified. In addition, it is justified to consider also the privatization of some parts of EPS. The liberalization of the activities performed by public enterprises would influence in different ways the improvement of their performances: the prices of their products would be brought to cost recovery level, the reduction of nonproductive costs would be necessary for the enterprises to be able to survive in the market, various direct and indirect forms of government assistance would become illegitimate as they would undermine competition. In addition to that, effective liberalization of electric power generation and rail transport would reduce the need for borrowing by EPS and Serbian Railways, limiting also the growth of Serbia's internal debt.

Public enterprises and other market participants face considerable problems with the collection of their receivables. The largest arrears towards public companies are those of enterprises in restructuring and local governments. The improvement of the collection of the receivables of the public enterprises can be achieved as a part of systemic measures for improvement of the overall financial compliance in Serbia. The problems relating to debts towards public companies by individuals can be solved through the combined implementation of social policy measures (for the poor) and enforced collection from other individuals.[101]

*Financial Non-compliance: Problems and Possible Solutions*

The problems with the collection of receivables by public enterprises are a part of the general financial non-compliance problem, which has a long-standing tradition in Serbia. A large number of market participants do not settle their liabilities within the agreed and statutory timeframes. In addition to that, the enterprises that have a dominent position in the market impose unsustainably long contractual terms for the settlement of their liabilities. From the point of view of fiscal consolidation, non-payment of taxes is an important form of financial non-compliance. Based on the lists of the largest tax debtors, it is quite certain that that largest portion of receivables on this account will not be collected or will be collected in a minimum percentage in relation to their total value. Public companies, which have relatively high receivables from state-controlled commercial entities, are in a similar situation.

The main cause of financial non-compliance is the continuous survival of insolvent enterprises in the market. Some of those enterprises, such as the enterprises in restructuring, are legally protected from enforced collection and initiation of bankruptcy procedures. The debts of insolvent enterprises are shifted across the economy, creating illiquidity chains. The accumulation of accrued liabilities is contributed also by a relatively expensive and protracted bankruptcy procedure. Inadequate legal solutions that fail to prevent systemic frauds by entrepreneurs who establish an enterprise, accrue liabilities, and then liquidate the enterprise – also contribute to increasing accrued liabilities. The actual global economic crisis only aggravated the systemic causes of financial non-compliance that existed even before the crisis.

Imposing financial compliance is an important condition for the improvement of the business safety and the overall business environment is Serbia. The main precondition for resolving the financial non-compliance problem is an efficient bankruptcy procedure that can ensure prompt elimination of insolvent enterprises from the market, at affordable costs. An efficient bankruptcy procedure requires both adequate legal regulations and education of

[101] In terms of electric power, power theft is not negligible either, and it is most acute in illegal slums.

all the participants in the above procedure. One of the preconditions for the efficient and non-selective enforcement of bankruptcy procedures is a relatively fast resolution of the status of enterprises in restructuring. Another measure that could improve financial compliance is specifying statutory timeframes for the settlement of liabilities. It is possible to adopt a legal solution shortening the timelines to 60 days immediately, and then over the next couple of years continue shortening them to 30 days. Shortening the period for the settlement of liabilities would make redundant very problematic proposals to extend VAT payment timelines or to introduce VAT invoicing after payment. What has to be done is to enforce financial compliance through the implementation of reforms, rather than try to adapt the tax system to financial non-compliance as a given and unchanging state.

***While the improvement of the management and improved cost efficiency would contribute to the improvement of the financial performance of public enterprises, in some cases it would be necessary to increase the prices of their services.*** That applies primarily to increasing the electricity and gas prices, which are currently considerably below the market prices. Increasing the prices of the above services is important also from the aspect of fiscal consolidation. While EPS and Srbijagas do not receive direct budget subsidies, the government has issued relatively high guarantees for their debts. If the prices of their services were to remain permanently below cost recovery, that could lead to the activation of the government guarantees for their debts. The increase of the prices of services of the above enterprises needs to be gradual, not only to protect the living standard of the population, but also due to the risk that the increased prices could be used to strengthen the inefficiencies of the cost side.

*8.3.3. Reform of Municipal Public Enterprises*

***The restructuring of municipal enterprises could result in a relatively large reduction of direct subsidies approved by local governments to utility companies*** (see Chapter on subsidies). The improvement of the performance of municipal public enterprises includes four groups of activities:

- Completion, improvement and enforcement of the legal framework for the performance of utility activities (a new law on utilities, use of public private partnerships and concessions, enforcement of the law on public ownership, etc.);
- Improvement of the management in municipal public enterprises (corporatization and other measures, as well as at the central level);
- Increasing prices to long-term cost recovery levels;
- Improvement of the cost efficiency of municipal enterprises (reducing the number of redundant employees, a more efficient public procurement, etc.; see Chapter on fiscal decentralization).

In respect to the municipal services that do not present natural monopolies, utility companies or parts of utility companies could be privatized, and some activities (public transport) could be liberalized. Potential public private partnerships need to be considered with utmost caution, as they can open a large room for corruption.

## 9. POSSIBLE SAVINGS ON SUBSIDIES

**Recent Developments and Issues**

The expenditures for subsidies in Serbia, taking into account not only the payments from the Serbian budget, but also the available data on all direct and indirect subsidies provided by all levels of government, are estimated at 4.6-4.8 percent of GDP, which is approximately 3 percent of GDP higher than the EU average. On the other hand, it can be noted that the efficiency of the subsidy program in Serbia is considerably lower that that in the comparable EU member states (e.g. lower value of agricultural produce exports per hectare of arable land, lower quality of rail services, etc.). Consequently, there is a need for a comprehensive reform of the subsidy system in Serbia to reduce the overall expenditures for these purposes and improve the efficiency of the subsidy program.

**Proposed Measures**

1. Gradual reduction of investment and employment subsidies (e.g. by 0.05 percent of GDP every year) and their limitation to major investments only. In addition to that, they need to be in a form of implicit subsidies (through providing land, etc.), rather than direct budget payments.
2. Abolishment of direct and indirect subsidies to the enterprises assigned to the Privatization Agency for a period of 2 years.
3. Revision of the structure and mechanisms for the approval of subsidies for the railways, in terms of the abolishment of the current operating subsidies (employee wages) and increase of investment subsidies, which would be intended only for investments in the priority projects.
4. Revision of the structure and mechanisms for the approval of subsidies for agriculture by reducing and revising the way of subsidizing the production itself and increasing the subsidies for investments in agricultural infrastructure, so that they provide an incentive for increased productivity and contribute to the elimination of the bottlenecks in the agricultural production.
5. Reduction of the subsidies to municipal utility companies, along with the improvement of the cost efficiency and increase of the prices of some utility services. Further approval of these subsidies needs to be conditioned on the implementation of the program for improvement of the performance of those companies. The savings and efficiency improvements would contribute to the privatization of those municipal public enterprises that do not have a character of a natural monopoly.
6. Abolishment of tax allowances for corporate income tax, as well as the reduction of other indirect subsidy programs, and ensuring alternative options for additional reduction of some of the existing subsidy programs, in case of need for an *ad hoc* government intervention (e.g. in the financial sector) due to the impacts of the economic crisis.
7. Improvement of the records on all forms of direct and indirect government assistance, which are currently incomplete particularly for extra-budgetary institutions and local budgets, as well as indirect subsidies at all levels of the government.

**Expected effects**

The potential savings on the expenditures for subsidies that would be achieved in this way are estimated at 1.6-1.8 percent of GDP, of which the savings at the level of 1 percent of GDP could be achieved in the short term (already in 2013), and the additional savings of 0.6 percent to 0.8 percent of GDP could be achieved in the medium term (in the next two to three years). Such subsidy system reform would contribute considerably to the fiscal consolidation process, but also to improving the efficiency and effectiveness of the subsidy programs in Serbia.

Normatively speaking, the subsidies should be awarded in a situation when, due to externalities, the quantity of specific goods or the volume of specific services without the government interventions would be suboptimal or when there is a need to overcome a temporary crisis in the development or survival of an enterprise. However, the practice in most countries is to have the more broadly defined subsidy programs, and subsidies are awarded also in the situations when it is necessary to ensure incentives for the economy and/or individuals to adopt certain economic behavior models. However, the government assistance programs in Serbia are designed on a basis that is considerably broader than the international practice, and the overall expenditures for subsidies are higher than that in other comparable countries. In addition to the amount, the differences between the government subsidy programs in Serbia and international practice include the structure and implementation mechanism and the efficiency of these programs. Thus, a dominant portion of the expenditures for subsidies in Serbia includes programs that: a) aim to compensate the business and investment climate disadvantages (e.g. investment and employment subsidies), b) aim to compensate low economic efficiency and disadvantageous market position of commercial entities (e.g. subsidies for municipal public enterprises, the railways, enterprises undergoing revival and reconstruction), c) essentially present cash assistance programs for specific categories of subsidy beneficiaries (e.g. agricultural subsidies). Such designed government subsidy programs make for a considerable portion of the overall public spending, while their impact on the economic growth and elimination of market irregularities is limited. Thus, while the expenditures for agricultural subsidies (as a share of GDP) in Serbia are not lower than those in the other countries in the region or the EU members states, the value of the agricultural exports per hectare of arable land, on average, is considerably lower. Consequently, based on the levels of expenditures for subsidies, their structure, implementation mechanisms, and good international practice, the government subsidy policy reform should have two goals:

a) to reduce the overall expenditures for subsidies (both direct and indirect);
b) to revise the subsidy program structure and implementation mechanisms.

As a result of those changes, the overall expenditures for subsidies (both direct and indirect) could be reduced while improving the efficiency and effectiveness of the subsidy programs.

### 9.1. Official Estimates of Volume and Composition of Subsidies in Serbia

***In accordance with the official data, the subsidies in Serbia exceed 2.6 percent of GDP, of which 1.8 percent of GDP are subsidies provided from the Serbian budget, and the remaining portion are direct subsidies by sub-national governments and various indirect subsidies.***

The systemic recording of the subsidies in Serbia was initiated a couple of years ago, primarily as a part of the preparation of the Report on State Aid, which marked a significant progress in terms of reporting on this public expenditure category, but the estimates are still not fully comprehensive and reliable. The Report on Government Assistance, in addition to direct subsidies, partially covers the data on the government assistance provided by sub-national government and extra-budgetary funds, and some indirect subsidies as well. In accordance with the Report on State Aid, the overall state aid in Serbia is estimated at approximately 2.6 percent of GDP (Table 9.1). However, the Report on State Aid does not cover all direct subsidies provided by all levels of government and all types of net budget borrowing (e.g. it does not include the subsidies for the FIAT project and municipal subsidies to public utility companies) and a considerable portion of indirect subsidies (repayment of commitments for issued guarantees, "linking of the years of service", arrears, etc.), as well as some of the subsidies provided from the own revenues of the extra-budgetary funds. Consequently, it is estimated that the overall expenditures for subsidies in Serbia exceed by 2-2.2 percent of GDP the estimated figure of 2.6 percent of GDP.

**Table 9.1 Overall Subsidies Awarded in Serbia and EU-10 Countries, 2010 (percent of GDP)**

| Category | Serbia | EU-10 | | |
|---|---|---|---|---|
| | | average | minimum | maximum |
| 1. Agriculture | 0.79 | 0.17 | 0.08 | 0.29 |
| 2. Industry and services | 1.79 | 0.96 | 0.04 | 2.68 |
| 2.1. Horizontal state aid | 0.55 | 0.25 | 0.02 | 0.61 |
| a) Research and development | 0.00 | 0.07 | 0.00 | 0.27 |
| b) Training | 0.00 | 0.01 | - | 0.03 |
| c) Employment | 0.15 | 0.05 | - | 0.20 |
| d) SMEs | 0.02 | 0.01 | - | 0.02 |
| e) Environment | 0.00 | 0.09 | - | 0.31 |
| f) Culture | 0.00 | | | |
| g) Revival and restructuring | 0.21 | 0.01 | - | 0.05 |
| h) Export promotion | - | | | |
| i) Other (crisis response measures) | 0.18 | 0.03 | - | 0.24 |
| 2.2. Sector-level state aid | 0.48 | 0.71 | - | 2.45 |
| a) Steel | 0.00 | 0.02 | - | 0.05 |
| b) Transport | 0.42 | 0.58 | - | 2.44 |
| *i) Railways* | *0.42* | *0.53* | - | *2.43* |
| *ii) Other transport* | *0* | *0.05* | - | *0.41* |
| c) Other | 0.06 | 0.11 | | |
| 2.3. Regional state aid | 0.81 | 0.18 | 0.01 | 0.50 |
| **TOTAL** | **2.64** | **1.13** | **0.15** | **2.89** |

Sources: For Serbia – Report on State Aid for 2010; for the EU – European Commission reports available at: http://ec.europa.eu/competition/state_aid/studies_reports/expenditure.html#2

***The overall state aid officially carried in the books in Serbia is considerably higher, by more than 1.3 percent of GDP, in relation to the EU-10 average.*** If we were to include also the above categories of direct and indirect subsidies that are not included in the official estimates, the actual difference in relation to the EU-10 would be even greater, at 3-3.2 percent of GDP.[102]

While the subsidy programs financed from the Serbian budget make for less than a half of the overall estimated expenditures for subsidies, their importance reflects in the fact that they finance activities of strategic significance for the economic development, which is why it is especially important that they should be designed in a way to maximize their impacts. In the Serbian budget expenditures for subsidies, the most balance significant items are the agriculture and railways subsidies, as well as other subsidies that relate primarily to investment and employment promotion (Table 9.2).

**Table 9.2 Movements of Serbian Budget Expenditures for Subsidies**

| | 2009 | | 2010 | | 2011 | | 2012* | |
|---|---|---|---|---|---|---|---|---|
| | In billion RSD | percent of GDP | In billion RSD | percent of GDP | In billion RSD | percent of GDP | In billion RSD | percent of GDP |
| Agriculture | 13.7 | 0.5 | 18.2 | 0.6 | 20 | 0.6 | 20 | 0.6 |
| Railways | 9.5 | 0.4 | 12.4 | 0.4 | 16 | 0.5 | 13 | 0.4 |
| Industry | 3.5 | 0.1 | 4.1 | 0.1 | 3.8 | 0.1 | 2.8 | 0.1 |
| Tourism | 1.5 | 0.1 | 2.5 | 0.1 | 2.9 | 0.1 | 2.7 | 0.1 |
| Culture | 0.3 | 0.0 | 0.4 | 0.0 | 0.5 | 0.0 | 0.4 | 0.0 |
| Roads | | 0.0 | | 0.0 | | 0.0 | 8.8 | 0.3 |
| Other | 5.4 | 0.2 | 6.8 | 0.2 | 11.3 | 0.3 | 14.8 | 0.4 |
| Total | 34.0 | 1.3 | 44.4 | 1.5 | 54.3 | 1.6 | 62.4 | 1.8 |

* Plan (including only expenditures from the Serbian budget)
Source: the Republic of Serbia Budget Law

## 9.2. Assessment of Potential Savings on Expenditures for Subsidies in Short to Medium Term

In accordance with the available data from various sources, it is estimated that the overall expenditures for state aid (both direct and indirect) provided by all levels of government range between 4.1 percent and 4.3 percent of GDP, and that the potential savings on this account would be between 1.1 percent and 1.3 percent of GDP, of which approximately 0.5 percent of GDP could be archived already in 2013, and the remaining portion would be achieved gradually over the next two to three years (Table 9.3).

***In the course of the EU accession process, the subsidy policy will have to be harmonized with the EU standards and directives.*** In that respect, while the adoption of the Law on State Aid was the key initial step, in the coming period, individual programs will have to be harmonized with the EU directives (e.g. the terms and conditions for the approval of state aid to the railways in the EU are stipulated explicitly under several directives, and in that respect, it would be necessary to ensure that the Serbian Railways procedures are harmonized with those rules). In addition to that, it is recommended to introduce the subsidy program

[102] Considering that based on the official data by the European Commission it is not possible to estimate the comprehensiveness of the data on state assistance in the EU countries, estimated divergence of the expenditures for these purposes in Serbia in relation to the EU-10 should be considered as the maximum, so that it would be more realistic to estimate that such divergence is somewhat lower, but still very significant.

impact assessment system, which would enable continued subsidy policy improvements and strengthen the impacts of these programs.

**Table 9.3 Table 9.3 Estimate of Overall Direct Expenditures for Subsidies and Overall Potential Savings (percent of GDP)**

| Types of subsidies | Estimated expenditures in 2012 | Estimated overall savings[103] | Savings in 2013 | Medium-term savings |
|---|---|---|---|---|
| **1. Direct subsidies** | **3.4-3.6** | **1.4-1.6** | **1.0** | **0.4-0.6** |
| 1.1. Investments and employment | 0.5 | 0.4 | 0.3 | 0.1 |
| 1.2. Restructuring and revival | 0.3 | 0.2-0.3 | 0.1 | 0.1-0.2 |
| 1.3. Municipal subsidies | 0.7 | 0.2-0.3 | 0.1 | 0.1-0.2 |
| 1.4. Other sector-level subsidies | 0.1 | 0.1 | - | 0.1 |
| 1.5. Agriculture | 1.1 | 0.5 | 0.5 | - |
| 1.6. Railways | 0.4 | 0.1 | - | 0.1 |
| 1.7. Science and environment | 0.3-0.5 | (-0.1) | - | (-0.1) |
| 1.8. Potential new subsidies (Smederevo Steel Mill, banks, etc.) | ... | ... | ... | ... |
| **2. Indirect subsidies** | **1.2** | **0.2** | **-** | **0.2** |
| 2.1. Tax expenditures | 0.6 | - | - | - |
| 2.2. Repayment of commitments for guarantees | 0.3 | 0.2 | - | 0.2 |
| 2.3. Other indirect subsidies (service buyoffs, etc.) | 0.3 | - | - | - |
| 2.4. Arrears (tax, utility services, etc.)[104] | 5.9 | - | - | - |
| **3. TOTAL SUBSIDIES** | **4.6-4.8** | **1.6-1.8** | **1.0** | **0.6-0.8** |

Source: Fiscal Council estimates based on data from various sources

Even though the analysis indicates a considerable room for savings on the expenditures for subsidies, it has to be noted that the achievement of those savings is conditioned to a great extent on the implementation of other structural reforms, such as the improvement of the business climate, the finalization of the restructuring of socially-owned enterprises, the improvement of the efficiency of public enterprises (including the increase of the prices of their services), etc. In that respect, the restructuring of the railways system is considered to be of special importance.

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[103] Considering that for the fiscal consolidation assessment purposes the impacts of tax expenditure reduction were included in the assessment of the tax reform impacts on the public revenue levels, these impacts cannot be taken into account one more time in the assessment of the potential savings on the expenditure side. Similarly, the implicit subsidies for "linking of the years of service" do not result in the creation of new expenditures at the point of "linking of the years of service", but to the creation of implicit commitments on that account in the future. Consequently, the impacts of the abolishment of all these types of subsidies cannot be included into the overall amount of potential savings on the expenditures for subsidies.

[104] Estimated stock of arrears as of the end of 2011. Considering that it relates to the cumulative arrears for several previous years, the amount of arrears cannot be included directly into the overall amount of indirect subsidies in 2012. The above amount of arrears is a sum of arrears of the enterprises undergoing revitalization and reconstruction, as well as state-owned (public) enterprises.

***The potential savings on subsidies to the economy are estimated at 0.3 percent of GDP in the short term, and additional 0.1 percent of GDP in the medium term.*** The expenditures for subsidies focused on incentives for the economy in 2012 were approximately 0.45 percent of GDP, and related to the greatest extend to subsidies for the FIAT project (approximately 0.3 percent of GDP), for the promotion of *greenfield* investments and for liquidity loans and other economic promotion programs (approximately 0.15 percent of GDP).

***The finalization of the implementation of the FIAT project in 2012 will open room for the reduction of subsidies by the above specified amount (0.3 percent of GDP).*** In respect to the *greenfield* investment promotion subsidies, it is considered that this approach is a relatively expensive mechanism to attract investments, and that its price reflects the level of inadequacy of the business and investment conditions in Serbia. In addition, in addition to the fact that it leads to subsidizing even those investments that would be realized without such incentives, approving investments on a case to case basis creates market distortions, putting some companies in an unfavorable position. That is why, in the course of the EU accession process, it will be necessary to revise this mechanism, which *de facto* undermines the EU state aid rules. Consequently, the conclusion is that these incentives should be reduced (e.g. by 0.05 percent of GDP every year, starting from 2013), and that the incentives, in general, should be limited only to major investments that create positive external impacts on the rest of the economy, and that they should be provided to the greatest possible extent in a form of implicit subsidies (through provision of land, etc.), rather than direct payments from the budget. As a compensation measure to attract foreign direct investments, in the short term, the major bottlenecks for investments should be eliminated (improving construction permit issuance process, speeding up other administrative procedures, revising quasi-fiscal duties, improving legal security through speeding up court procedures and improving the enforcement procedure, etc.) should be eliminated.[105]

***Liquidity loans and other economic promotion programs (procurement of transport equipment based on the principle "old for new", etc.) are crisis-response measures, intended to mitigate the impacts of the global economic crisis.*** Should the crisis continue or deepen in 2012, there will be a need for recession-response economic promotion programs, which means that the possibilities for the elimination of these expenditures in the short-term are limited. However, such programs should be designed so that they provide incentives in terms of the promotion of the production for export, rather than domestic consumption of goods whose considerable portion of value added is created abroad. Should the economy recover in 2013 or the following years, it would be justified to reduce the expenditures for these purposes.

***The savings on the subsidies for revitalization and reconstruction of enterprises are estimated at 0.2-0.3 percent of GDP in the medium term.*** The direct subsidies for the enterprises undergoing revitalization and reconstruction in 2012 have been approximately 0.3 percent of GDP. However, in addition to direct subsidies, these enterprises receive also indirect subsidies in a form of tolerated arrears for unpaid commitments, as well as in a form of pension and disability and contributions financed by the state, for the employees in these enterprises, for whom the employers failed to pay the contributions in the past (so-called ”linking of the years of service“). The cumulative arrears of these enterprises have been estimated to approximately EUR 1.5 billion (approximately 5 percent of GDP), the largest portion of which relates to unsettled liabilities for tax and contributions, and the related

[105] Arsic, M. (2010).

penalty interest, while a smaller portion relates to the arrears for unsettled commitments towards utility companies, for the delivered services.[106]

The revitalization and restructuring expenditures are a result of the incomplete privatization process, which includes approximately 450 enterprises in Serbia, with approximately 90,000 employees (400 small and medium-sized enterprises with approximately 30,000 employees and 50 large enterprise systems with approximately 60,000 employees). Considering that these are enterprises that have been in the process of privatization for years, and that a potential buyer was not found even before the onset of the global economic crisis, and that their market position is deteriorating with time, the conclusion is that the issue of these enterprises needs to be resolved in a relatively short period (up to two years) byway of: a) finding potential buyers (particularly for large enterprise systems), or b) bankruptcy and liquidation of those enterprises for which it is concluded that they have no chance to be privatized. That would contribute also to the improvement of the performances of the economy as a whole, as these enterprises are often illiquidity generators.

Considering the financial and market position of these enterprises, it is estimated that the largest portion of their arrears in not collectable. On the other side, while the indirect subsidies for "linking of the years of service" do not create additional cash outflows from the budget in the current period, they do create future state obligations (for future pension benefits). Consequently, the potential savings on the subsidies for enterprises undergoing revitalization and restructuring in the short to medium term relate primarily to the savings on direct subsidies. It is estimated that the savings on this basis, primarily from extra-budgetary funds, would be approximately 0.2-0.3 percent of GDP (considering that in 2012 these expenditures have been approximately RSD 9 billion or approximately 0.3 percent of GDP). However, considering that that is a complex process that takes time, a realistic goal would be to reduce these expenditures by 0.1 percent of GDP each year, starting from 2013.

***Some savings could be achieved also through the reform of public utility companies.*** In 2012, the municipal subsidies in Serbia have been approximately 0.7 percent of GDP, and have related to the greatest extent to the assistance to municipal utilities (public transportation, heating, and water supply). Considering the condition of the municipal utility infrastructure, as a consequence of under-investing in the previous two decades, it is necessary to keep a certain form of subsidies to municipal public enterprises, which would focus on the improvement of the relevant infrastructure and projects resulting in the improvement of their efficiency and the quality of their services. The improvement of efficiency, through the improvement of technical capacities, business processes, and the reduction of the number of employees, followed by an increase of the prices of these services (even only to the cost and depreciation recovery level), conditioning of subsidies, and a phased increase of the prices by improving the operating productivity and the overall efficiency of public utility companies, and the privatization of municipal public enterprises that do not have a character of natural monopolies (e.g. local media, sanitation company, etc.) – would open room for the reduction of the subsidies for these purposes from the municipal budgets (by 0.2-0.3 percent of GDP).

***The potential savings from the abolishment of other sector-level subsidies would be approximately 0.1 percent of GDP in the medium term.*** In 2012, approximately 0.1 percent of GDP has been spent for the subsidies for the Resavica Coal Mines, as well as for the

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[106] It is estimated that the largest portion of the liabilities of these enterprises that relates to taxes, contributions and other duties and the related penalty interest is uncollectible. However, the write-off of such receivables by the state should be considered with utmost caution to ensure the state share in the bankruptcy/liquidation estate (in case of their bankruptcy/liquidation).

assistance to financial institutions (assistance to Agrobanka, etc.). Should there be no need for such state interventions in the financial sector in the following year, which would result in the reduction of the expenditures for subsidies by 0.05 percent of GDP. In addition to that, in the medium term, savings on the subsidies could be achieved also though the restructuring and privatization of other sector-level subsidy beneficiaries (primarily, Resavica Coal Mines). The savings on this basis would not be considerable and would be up to 0.05 percent of GDP.

***The reform of the agricultural subsidies should focus on the revision of the structure and approval mechanisms.*** The overall expenditures for the agricultural subsidies in Serbia in 2012 have been estimated at approximately 1.1 percent of GDP, of which the Serbian budget subsidies account for 0.6 percent of GDP, and the subsidies from various extra-budgetary funds account for additional 0.5 percent of GDP.

The dominant share of the agricultural subsidy programs are the subsidies for farms, which were linked, in 2011 and the previous years, to the production factors (subsidies per hectare of arable land, regressed price of diesel fuel, etc.), and which were essentially cash assistance programs for farms which did not condition the level of subsidies on the achieved results. Such programs were implemented in the EU countries at the beginning of the 1990s, with the aim to reduce the surplus agricultural production and enable the realization of the accumulated stocks. The number of beneficiaries of direct agricultural subsidies is relatively small in relation to the overall number of agricultural producers, and the average level of subsidy per farm in Serbia is approximately EUR 1.600 annually, which is considerably higher than in the other countries in the region (e.g. Romania gives approximately 245 EUR, and Poland gives 1,065 EUR). On the other side, the agricultural exports per hectare of arable land in Serbia are lower than in almost any EU-10 country. That suggests that the existing agricultural subsidy system is inefficient. A partial revision of the approval instrument for agricultural subsidies has been announced for 2012, and would aim to link them to the actual yield (the so-called subsidies per kilogram of product). Even though such revised criteria for the approval of agricultural subsidies should be an incentive for a more optimum use of land and higher productivity, it is considered that it would still not be enough to eliminate the main bottlenecks for accelerated agricultural output growth. These bottlenecks relate to the lack of infrastructure for storage and transport of agricultural products and the underdeveloped supply chain, which are supposed to ensure the quality, quantity, and continuity of supply, as a precondition for a more significant export of agricultural and food products. That is why it is considered that in the coming period in will be necessary to increase the budget allocation for agricultural subsidies for investments in the above infrastructure. Considering that the agricultural subsidies in Serbia (as a share of GDP) are already relatively high, and that there is not room for further increase, the conclusion is that a reform of the agricultural subsidy system has to include the reduction of direct subsidies for farms and proportionate increase of the subsidies for investments in the priority agricultural infrastructure, which would ensure the increase of productivity and agricultural export levels.

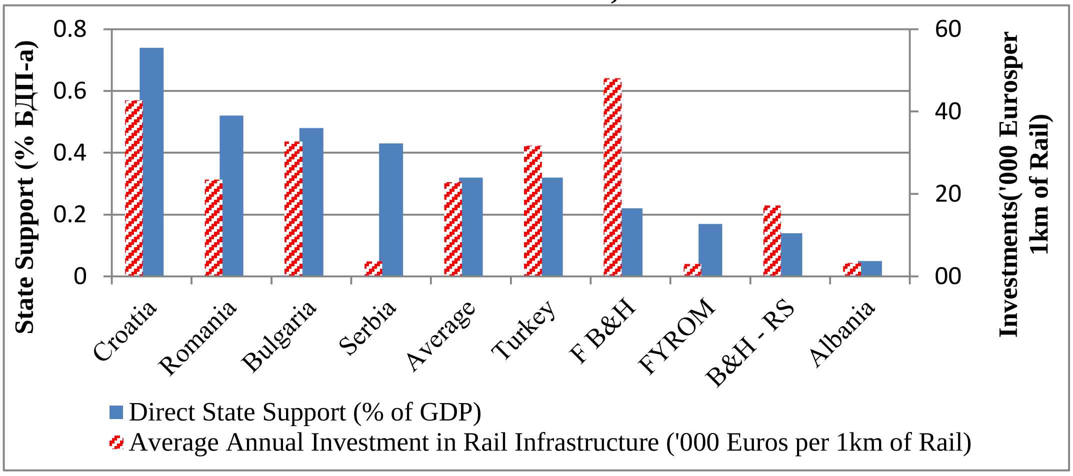
In accordance with the Report on State Aid in EU-10, the state aid for agriculture (as a share of GDP) in these countries was, on average, considerably lower than that in Serbia. However, the EU member states can count on the agricultural support provided from their national budgets, as well as on the EU post-accession funds (e.g. SAPARD program). A specificity of the accession process in terms of the agricultural policy reflects in several times higher levels of assistance from the EU funds after the membership in relation to the pre-accession period (e.g. in the course of the accession process, Croatia received approximately EUR 25 million from the IPARD program annually, and it is estimated that after they become a member they will receive approximately EUR 310 million annually for agriculture and rural policy). On the other side, in accordance with the Stabilization and Accession Agreement, the average custom rate for import of agricultural products from the EU countries to Serbia in 2009 was 19 percent, and by 2013 it will be reduced to the average of 1.7 percent. After the full liberalization of trading in agricultural products with the EU is nearly achieved (2013) and until the full membership status – there will be a period of several years, during which the market of agricultural products will be open to a strong competition by the EU producers, while the assistance from the EU funds will be relatively modest. In addition to that, the EU and World Trade Organization accession processes will imply a range of institutional and structural adjustments, which will require adequate funds provided in the budget. That is why it is considered that during that period there will be no room for a notable reduction of agricultural subsidies from the national budget. On the other side, the payments for these purposes from the own revenues of extra-budgetary funds totaling 0.5 percent of GDP in 2012 are seen as a one-off assistance, not connected directly to the general agricultural policy, and that is why it is considered that they should not be used in the coming years.

A certain, albeit modest, impact on the country's fiscal balance could be achieved also through a reform of the agricultural land taxation. While the Law on Property Taxes does stipulate the obligation to pay tax on agricultural land, that provision has been frozen for years, which is de facto a tax allowance, i.e. tax expenditure. The enforcement of this tax, which is relatively low, would result in the reduction of tax expenditures (i.e. increased revenue), and it would serve as an incentive to start cultivating previously uncultivated land, which is considered particularly important.

***There is a need to revise the structure of the railways subsidies and reduce the subsidies for current operations, while increasing the investment subsidies.*** In 2012, the direct expenditures for the railways subsidies in Serbia have been approximately 0.4 percent of GDP, which is at the multiannual average level, and as such they in the second place most for the balance significance significant balance (after agriculture). In terms of the railways subsidies as a share of GDP, Serbia is ranked fourth among nine countries/entities in the region that were analyzed. The expenditures for the railways subsidies were higher in Croatia, Romania and Bulgaria, and somewhat lower in the other countries/entities in the region (Graph 9.1). In relation to the new EU members, Serbia's expenditures for the railways subsidies are comparable (i.e. somewhat lower). However, in addition to direct subsidies, Serbian Railways receives also indirect subsidies, for the accumulated tax arrears and arrears for the delivered goods and services by the suppliers (particularly state-owned enterprises). The overall arrears of all state-owned enterprises in Serbia are estimated at approximately 1.2 percent of GDP (tax arrears make for approximately 0.9 percent of GDP, and other arrears for approximately 0.25 percent of GDP), the largest portion of which relates exactly to the arrears of the railways system. In addition to that, Serbian Railways is an important beneficiary of the government guarantees for loan extended mostly by the international financial institutions for investments in infrastructure and fixed assets. It is estimated that the overall state expenditures for the guaranteed loans to state-owned enterprises in 2012 would be 0.2-0.3 percent of GDP, of which a significant portion relates to the repayments under guarantees issued for the loans taken by Serbian Railways. Consequently, it is considered that the overall state aid to the railways system in Serbia exceeds the above level of direct subsidies.

On the other side, the quality of the railways infrastructure in Serbia is very low in relation to other countries (in accordance with the World Bank report *Doing Business*, Serbia is in the 95$^{th}$ place in the world in terms of the railways infrastructure quality). The main characteristics of the railways system in Serbia are as follows: a) irrationally large railway network (approximately 3.800 kilometers), of which only 31 percent is electrified, and 7 percent is dual-gauge railways, b) low quality of services, and c) low volume of services and low productivity. The operating revenue of Serbian Railways can cover merely 50 percent of their operating expenses, which puts Serbia in last place but one in relation to the other countries in the region (only Turkey has a lower coverage level – shown in Graph 9.2).

**Graph 9.1. Direct State Aid for the Railways and Investments in Railways Infrastructure in SEE Countries, 2010**

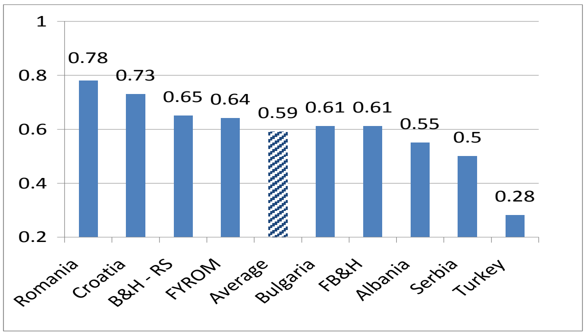



Source: Monslave, C. (2011)

The cause of such poor performance of the railways is its poor, oversized and over-depreciated railways infrastructure and low productivity. While in terms of the direct railways subsidies as a share of GDP, Serbia is in the fourth place among the nine countries in the region that were considered, in terms of the level of investments in the railways infrastructure, Serbia is ranked seventh (among the nine countries in the region that were considered), with the investments per kilometer or railway approximately six times lower than the average for the region. On the other side, the total productivity of the railways system in Serbia is only approximately 30 percent of the EU-27 average presented in Graph 9.3. The low productivity problem is especially acute in the passenger transport segment (18 percent of the EU-27 average) and labor productivity (29 percent of the EU-27 average).[107]

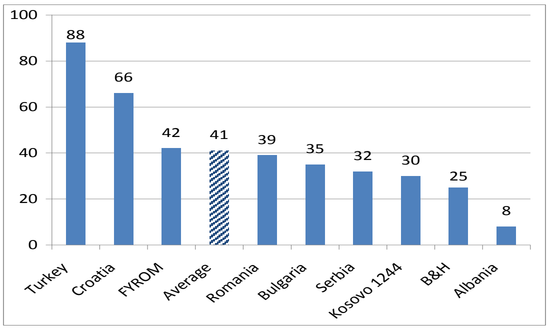
Such findings point to the conclusion that the structural problem undermining the sustainability of the railways system is a low quality of services, resulting from the oversized railway network and low investments, and a significant employment surplus in relation to the actual needs.

**Graph 9.2 Operating Revenue/Operating Expenditures Ratio in SEE Railways Systems**




Source: Monslave, C. (2011)

**Graph 9.3 Railways Productivity in SEE (percent, EU-27 = 100)**




Source: Monslave, C. (2011)

107 See: Monslave, C. (2011)

Based on the above, it is concluded that there is room for the reduction of operating costs in the system (through the rationalization of the railway system and improvement of productivity, i.e. employment downsizing). However, considering that the quality of the railways infrastructure and services is quite low, and that the existing level of the railways infrastructure investments is considerably lower than the actual needs and the average in the region, the long-term sustainability of the railways will depend, to a considerable extent, on the level and good targeting of investments. Considering that the quality of the existing infrastructure is considerably lower than that in the comparable countries, in the coming period, it will be necessary to ensure larger than average investments in this area. That is why it is concluded that the potential savings on operating expenses combined with the increase of the prices of services (as the quality improves) would result in freeing the resources for larger investments, but that in the medium term, there is no significant room for the reduction of the overall railways subsidies, considering that most countries support in some way capital investments in the railways sector from the national budgets (through subsidies, public investments or guarantees). That is suggested also by the comparative data for the EU member states, almost all of which allocate a certain level of funds for the state aid to the railways, which indicates that even in other countries the railways system is not self-sustaining. In accordance with the above, it is considered that there is limited room for the reduction of the overall railways subsidies in the short and medium term, and that after the railways system is restructured (unbundling infrastructure and transport, etc.), the productivity increased, and the infrastructure brought to the adequate level, in the long term, it would be possible to achieve some savings for these purposes (at the level of approximately 0.1 percent of GDP).

***In the medium term, there is a need to increase the subsidies for research and development, as well as for the environment.*** The direct subsidies for research and development are exceptionally low in relation to the international comparisons, which is considered unfavorable, considering that the investments in research and development can potentially have considerable positive external impacts by accelerating economic growth in the long term. Consequently, the number of applied studies and the level of dissemination of the study findings, through innovations and patents, are very low. In accordance with a broader definition, the subsidies for research and development could include also the salaries for the employees in scientific institutes, and the remuneration for the authors hired on scientific research projects by the Ministry of Education and Science. These expenditures are estimated at 0.3 percent of GDP (approximately RSD 10 billion). Various analyses show that by 2020 the overall expenditures (both private and public) for research and development should reach 2 percent of GDP. The largest portion of those funds would still have to be provided by the private sector, with the public sector supporting such activities under their programs. Based on the expenditures for research and development in other comparable countries (EU-10), and the specified objectives, the conclusion is that, in the coming period, there will be a need to increase the expenditures for these purposes (even more so considering that the project funding in these areas from the EU funds is often conditioned on co-financing by the candidate country), which would have a positive impact on these activities, without influencing considerably the increase of the overall expenditures for these activities (up to 0.05-0.1 percent of GDP). In addition to that, it will probably be necessary to reconsider the existing system of subsidies for research and development in order to promote innovations.

The funds earmarked for environmental protection are administered to a great extent through various extra-budgetary funds, which is why there is no official estimate of the overall amounts spent for these purposes. Considering that a large part of both formal and essential obligations in the EU accession process relates to environmental improvements, and that the expenditures for these purposes in Serbia are considerably lower that in the comparable countries, it is estimated that, in the medium term, there will be a need to increase subsidies for these purposes relative to the existing official estimates by 0.05-0.1 percent of GDP.

***It is possible that there will be a need for additional subsidies to commercial entities of importance for the stability of the country's economic and financial systems.*** In the conditions of a relatively high uncertainty in terms of the movements of the commercial activity both at a global level and in the country, and the potential associated risks, it is possible that there will be a need for additional *ad hoc* state aid programs for commercial entities whose decline could have broader repercussions on the stability of the country's economic and financial systems. In that respect, it is estimated that this possibility is most likely in the case of the potential assistance to Smederevo Steel Mill, which will not be necessary if a new strategic partner is identified, and to some banks, which could have illiquidity/insolvency problems due to a large volume of uncollectible loans. However, due to uncertainty about whether Smederevo Steel Mill would be privatized again in the foreseeing period, and about the level of the prospective assistance that might be required for banks, it is not possible to estimate with reasonable certainty the potential expenditures on this basis. However, the conclusion is that the expenditures for subsidies need to be projected with a certain level of flexibility to allow for the reallocation of funds to such purposes as well, should the above risks arise, without increasing the overall level of public expenditures.

***The savings on the tax expenditures at the level of 0.2 percent to 0.3 percent of GDP could be possible in the medium term.*** Tax allowances approved to tax payers through various forms of tax incentives reduce tax revenue, and, as such, need to be presented as state aid in a form of tax expenditures. In the Report of State Aid for 2010 they are estimated at approximately 0.6 percent of GDP, primarily relating to corporate income tax allowances. Should the tax reform strategy in this domain focus on narrowing down and eliminating various corporate income tax allowances, due to the fact that the statutory corporate income tax rate is already low, that would lead to a reduction of tax revenues on this basis. However, the most significant portion of tax expenditures is the investment tax credits, which can be carried forward for five subsequent years (until two years ago, the carryforward period was 10 years). That is why a potential reduction or abolishment of these allowances in 2013 would not result in a significant reduction of tax expenditures on this basis in the same year, but rather to their gradual scaling down over the next seven to eight years.

As the impacts of the savings on tax expenditures were already taken into account in the assessment of the tax reform balance impacts, they cannot be considered one more time in the assessment of the overall savings on the expenditures for indirect subsidies.

To conclude, the direct and indirect expenditures for subsidies in Serbia are considerably higher than those in the comparable countries, new EU members, who reduced these expenditures very quickly by approximately 20 percent, on average, in the period preceding the formal membership. In accordance with the economic theory, the subsidies from the national budget are justified only in case of external impacts or when the market cannot provide certain goods in adequate quantities and in an efficient manner without the state intervention or when there is a need to bridge a temporary crisis. A restrictive approach to the subsidy policy is recommended, considering that subsidies disturb relative prices, causing market distortions, in addition to burdening the fiscal balance. However, the practice in most countries is that the state aid programs are broader than it is recommended, often for political reasons. While the situation in Serbia is similar, the range of different direct and indirect state aid programs is more extensive and broader that in most comparable countries.

***The overall state aid in Serbia exceeds 4.5 percent of GDP and is higher than that in other comparable countries.*** In accordance with the official data from the Report on State Aid, the overall state aid in Serbia is approximately 2.6 percent of GDP. However, as the above Report does not include all forms of state aid, the actual overall level of state aid can only be roughly estimated. In accordance with the available information, it is estimated that the overall state aid in Serbia is 4.6-4.8 percent of GDP, and that, as such, it is considerably higher than in other comparable countries. It appears that in this segment of the state spending there is room to achieve considerable savings (between 1.6 percent and 1.8 percent of GDP), of which approximately 1 percent of GDP could be achieved in the short term, and the additional 0.6-0.8 percent of GDP could be achieved in the medium term. The most significant savings could be achieved through the reduction and abolishment of the subsidies for investment and employment and for restructuring and revitalization of enterprises, through the abolishment of various heterogeneous tax allowances, and the reduction of municipal subsidies, primarily to public utility companies. On the other side, the risks associated with the prospective deepening and continuation of the economic crisis could result in the need to ensure additional *ad hoc* subsidies (as was the case in 2012 with the subsidies for Agrobanka and the takeover of Smederevo Steel Mill). Notwithstanding the uncertainty of those risks materializing and the inability to estimate with certainty the potential expenditures on this basis, there is a need to develop a contingency plan for the reallocation of the expenditures for subsidies or to ensure a certain level of provisions within the expenditures for subsidies, in case of urgent need for such interventions, without increasing the overall level of the expenditures for subsidies. In addition to the reduction of the expenditures for subsidies, there is a need to introduce/improve the program impact monitoring system to allow for monitoring of individual subsidy programs, and to introduce an obligation to report on the subsidy program impacts to the Parliament.

The experience of other transition economies shows that programs for considerable reduction of the expenditures for subsidies can be implemented in a relatively short time, under the assumption that they have a clearly specified program objective that implies the reduction of public spending and the improvement of the efficiency of the subsidy system, and the transitional rules that can ensure the implementation of those measures without undermining the system operations and without causing too much social resistance.

# 10. FISCAL DECENTRALIZATION

**Recent Developments and Issues**

The main issues in the area of fiscal decentralization and local public finance are: the imbalanced allocation of revenues and expenditures between the central and the local government, low efficiency and limited competencies of the local government. The vertical imbalances reflect in the surplus of the local government revenues in relation to their competencies and the central government revenue shortage in relation to the central government competences at the level of 0.6-0.7 percent of GDP. This vertical imbalance presents an urgent problem, causing fiscal deficit and increase in public debt, and needs to be solved in the short term. The mid-level government in Serbia is characterized by an acute asymmetry – the autonomous provinces, which are the integral parts of Serbia, have extensive autonomy, while central Serbia is divided into statistical regions with very limited competencies.

**Proposed Measure**

***a) Short-term Measures***

1. In 2012, the central government would adopt measures to prevent wage inflation and employment growth at the local level, encouraging the local governments to reduce arrears, increase investments, and improve the situation in the local budgets.
2. From the beginning of 2013, measures aiming to ensure a sustainable fiscal decentralization would be implemented, including the increase of the central government share in payroll taxes to 60 percent. Alternatively, some functions would be devolved from the central to the local level.

***b) Medium to Long-term Measures***

3. Measures to directly influence the improvement of the situation in the local budgets: reducing employee numbers at the local level, reducing subsidies to utility companies, improving cost-effectiveness of investments, restitution of property to the local governments.
4. Measure to indirectly influence the improvement of the efficiency of local governments: strengthening competition between local governments, improving transfer policy, and political decentralization.
5. Measures for the improvement of business climate at the local level: reducing administrative barriers and corruption at the local level and improving local taxes.
6. Gradual increase of the local governments' competencies in education, health, and social welfare through gradual devolution of competencies and revenues from the central level to local governments.
7. Gradual and selective increase of regional competencies in the function of improving the efficiency in the government sector.

**Expected Effects**

*The short-term measures* would enable the reduction of the local governments' arrears, the growth of investments, and the improvement of the local government balances. Increasing the central government share in the allocation of payroll tax revenues would result in the reduction of the consolidated fiscal deficit by 0.6-0.7 percent of GDP. In addition, payroll

tax would become once again a predominantly central level tax, which would facilitate its reform.
*The medium to long-term measures* would result in the savings of approximately 1 percent of GDP, with the current level and quality of services. Improving the business environment would contribute to the investment and employment growth, and in turn the revenue growth at all levels of government. The quality of public services could be improved, with the same share of expenditures in GDP, if some education, health and social welfare functions are devolved to the local level after extensive preparations. Delegating some competencies to the regions could contribute to increased efficiency of the general government.

The main issues in the area of fiscal decentralization and local public finance are: the vertical imbalance in the allocation of revenues and expenditures, low efficiency and limited competencies of the local government. The vertical imbalances reflect in the surplus of the local government revenues in relation to their competencies and the central government revenue deficit in relation to the central level competences at the level of 0.6-0.7 percent of GDP. The vertical imbalance presents an urgent problem, causing fiscal deficit and increase in public debt, and needs to be solved in the short term. The vertical imbalance could be eliminated by increasing the central government share in the payroll tax or by devolving some of the competences from the central to the local level. Low efficiency at the local level requires comprehensive reforms that need to result in the reduction of unproductive expenditures such as: excessive labor costs, high subsidies to utility companies, improving public procurement, and improving the work of local administration and reducing corruption. The increase of the competencies of the local government in the education, health and social welfare areas with the respective increase of their share in public revenues has to be in the function of improving the efficiency of the general government, and therefore requires extensive preparations. The mid-level government in Serbia is characterized by an acute asymmetry – the autonomous provinces, which are the integral parts of Serbia, have with extensive autonomy, while Serbia proper is divided into statistical regions with very limited competencies. That raises a question that might not be as urgent as it is important: is it justified to increase the competencies of the statistical regions and what is the timeline for doing so?

## 10.1. Status and Trends

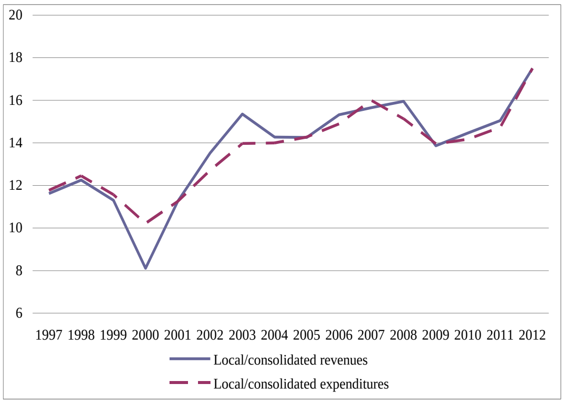
***Over the past couple of decades, the competencies of the local governments varied widely*** – from very extensive competencies in the self-management times to a marked centralization in the late 1980s and the early 1990s, and back to a moderate decentralization from the beginning of transition. The institutional failures, decline in economic activity and increase of poverty in the 1990s had a negative impact on the volume and quality of local services. In the previous decade, local services were improved considerably, but in some areas the situation is still not satisfactory.

***In the period 2001-2008, the revenues and expenditures of the local governments recorded continuous growth exceeding not only GDP growth but also the consolidated public revenue and expenditure growth.*** Until 2008, the increase in the revenues of the local governments was caused, to a large extent, by a imbalance between their obligations and revenues, which culminated in the 1990s. In the period 2001-2008, both the exclusive and delegated revenues of the local governments and the transfers to the local governments were increased. For the first time, the system of transfers in Serbia was regulated in a systemic manner, ensuring a sound basis for its subsequent improvements in accordance with the best international practice. The increased revenues of the local governments made possible the reconstruction of the under-maintained utility infrastructure, improvement of social functions (improvement of child protection, reconstruction of schools, etc.), improvement of the local administration capacities, etc.

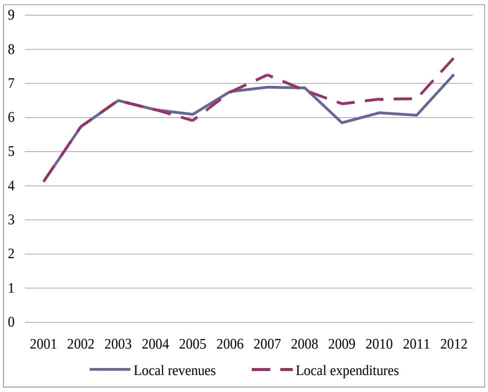
***With the onset of the economic crisis, the local governments bore a larger part of the fiscal adjustment burden than the general government sector.*** The Serbian budget transfers were reduced by 0.5 percent of GDP, while the local governments' share in the consolidated revenue declined for the first time after eight years of continuous growth. The local governments' revenue from real-estate transaction tax recorded a further decline, especially in the cities, due to a dramatic decline in the volume of real-estate transactions. As a result of the reduced transfers and the decline of own revenues, the local governments' share in the consolidated revenue in 2009-2010 declined by 1.5 percentage points relative to the previous two-year period – shown in Graph 10.1.

**Graph 10.1 Relative Significance of Local Revenues and Expenditures by Years**

**Share of Local Budgets in General Government Consolidated Budget ( percent)**




**Local Revenues and Expenditures ( percent of GDP)**




Source: Ministry of Finance

***The amendments to the Law on Financing of Local Government came into effect at the beginning of the fourth quarter of 2011.*** The above Law increased the local governments' share in the payroll tax from 40 percent to 80 percent. Belgrade ceded 10 percentage points of payroll tax revenues to the Solidarity Fund, with the aim to mitigate the initial regressivity of the proposed Law. As a result of the above changes, the local governments received additional revenues at the level of 1.5 percent of GDP, without any additional obligations. Subsequently, the local governments took over the local road maintenance, and assumed the commitments at the level of approximately 0.3 percent of GDP from the central level. In accordance with that, in 2012, approximately 1.2 percent of net revenue has been devolved from the central level to the level of local governments. The increase in the local governments' revenue as a share of overall revenue and GDP in 2012 has been considerably higher than the reduction of the above revenue in the period 2009–2010. The share of the local governments' revenue in the last quarter of 2011 and the first two months of 2012 was 17.6 percent, which was 2 percentage points higher than in the pre-crisis period, i.e. 2006–2008. The local governments share in the consolidated revenue in 2012 will be 3 percent higher relative to the crisis period 2009–2010 as shown in Table 10.1. In accordance with that, if the pre-crisis years are taken as the public revenue allocation benchmark, and if it is assumed that all levels of government should bear equal burden of the crisis, the local governments received additional resources of 0.6 to 0.7 percentage points of

GDP, relative to such specified level, for which they had no additional obligations. Symmetrically, the Serbian budget lost revenues in the same amount, without having been freed from any obligations. Based on all of the above, it can be concluded that the Law on Financing of Local Government created a notable imbalance between the central level and the local governments' revenue and expenditures (the so-called vertical imbalance).

**Table 10.1 Relative Levels of Local Governments' Expenditures in Serbia**

| | 1997–2000 | 2001–2003 | 2004–2006 | 2007–2008 | 2009–2011 | 2012 |
|---|---|---|---|---|---|---|
| Local/consolidated expenditures, percent | 11.5 | 12.6 | 14.4 | 15.6 | 14.3 | 17.5 |
| Local expenditures, percent of GDP | | 5.4 | 6.3 | 7.0 | 6.5 | 7.7 |

Source: Ministry of Finance

***The negative impacts of the vertical imbalance between the revenue and expenditures were already recorded in 2011 and the first quarter of 2012.*** Had the local governments' share in revenues been returned to the pre-crisis levels, increased by the cost of local road maintenance, the consolidated government fiscal deficit in the previous year would have been 0.2 percent of GDP lower, i.e. at the level of approximately RSD 8 billion. Similarly, in the first quarter of this year, the fiscal deficit would have been lower for approximately RSD 8 billion if the local governments' share in the consolidated revenue had been returned to the pre-crisis levels. Based on the above, it can be concluded that the net impact of the reallocation from the central to the local government level in 2012 would be approximately RSD 25 billion.

The question now is how the above allocation would impact the public finance in Serbia at the macro and micro level. At the macro level, if nothing is changed at the central government or local government levels, the above reallocation will increase the structural systemic fiscal deficit by 0.6-0.7 percent of GDP. The increase in the structural fiscal deficit means *inter alia* that, if all other conditions remain the same, the public debt will grow at an accelerated pace of approximately 0.6-0.7 percent of GDP annually, i.e. that the public debt will increase by additional EUR 200-250 million annually.

The state government efficiency, measured as the ratio of the volume and quality of public services (education, health, administrative services, social welfare, infrastructure, security, etc.) and the cost of service delivery (tax rates and structure, the level of public debt), is an important determinant of the economic and overall social progress. The efficiency of the state services is similarly important, as well as the size of the public sector measured as the public expenditures or taxes as a share in GDP.

***Various indicators point to the conclusion that the efficiency of the overall government sector in Serbia is low[108], and that some of the largest irrationalities are recorded at the local government level.*** Low efficiency reflects in both high service provision costs and low quality and inadequate volume of services. The most balance significant irrationalities on the cost side include:

- large employment numbers and relatively high wages,

[108] The indicator of the low quality of education include: poor student achievements in the PISA assessment, long length of study before graduation, and a small number of papers by out scientists published in international publications. Slow, expensive, and often low-quality infrastructure construction at all levels of government points to state inefficiencies in this area. Similar conclusions can be drawn also based on measuring the impacts of subsidies, administrative or health services.

- high subsidies to utility companies,
- cost inefficient procurement of goods and local investments.

Some of the most important indicators of the low quality of local services include:

- low quality of administrative services,
- low quality of local investments,
- inefficient tax system and tax collection.

The local governments' cost inefficiencies have a direct impact on the expenditure increase and deficit growth in the local budgets, while the low quality of local services reduces future revenues and increases future expenditures, and has a negative impact on the business environment and the economic development potentials.

> *Local Governments are Heterogeneous*
>
> Local governments are a numerous and heterogeneous group and mutually differ in their population, size of territory, level of development, distance from the main transport routes, etc. That influences large disparities in the levels of their budget per capita and efficiency of service delivery. That is why all assessments of the local government efficiency use the average, which means that some municipalities and cities can achieve a relatively high efficiency often with modest resources.

***The cost of labor at the local government level in 2011 was RSD 46 billion or approximately 30 percent of the overall local budget costs or 1.4 percent of GDP in Serbia.*** While fully reliable and up-to-date data regarding the number of employees at the local government level is not available, it is estimated that the local budgets are financing approximately 60 thousand employees[109], of which approximately 23 thousand the local administration employees. Based on comparative analyses of the number of employees in local governments in Serbia with similar characteristics (population, territory, number of preschool children, number of students in elementary schools and high schools, etc.), it is estimated that at the level of local governments there is a surplus of six to eight thousand employees. Similar estimates can also be made based on the international comparisons of the number of employees at the local level relative to the overall population.[110] In addition to that, the wages at the local government level are somewhat higher than the central government wages and much higher than the private sector wages. It is estimated that the employment surplus at the local government level creates unnecessary costs at the level of approximately RSD 6 billion or approximately 0.2 percent of GDP.

In 2009, a law was adopted stipulating the reduction in the number of employees in local administrations, the transfers to local governments were reduced, and a strong media campaign on the comparison of positive and negative examples was implemented. In spite of that, the number of employees at the local government level remained virtually unchanged. The local governments' resistance to the pressures to reduce the number of employees is rooted primarily in the high general unemployment rate (those who are laid off would have little chance to find any job), but also in relatively high wages in the local governments. The

[109] The figure of approximately 60 thousand employees can be derived indirectly based on the overall cost of labour and operating costs per employee.

[110] In international comparisons, it has to be taken into accounts that local communities in Serbia currently have more narrow competencies, and the number of employees in relation to the overall population should be lower then internationally. That is why this estimate of the labor surplus at the local level may be treated as the minimum.

difficulties in term of the reduction of the number of employees in the local sector are to a great extent a consequence of political and social factors. Local governments and local enterprises are institutions that often employ party activists, and the redundancy programs are obstructed by the local government management. In addition to that, in the society in which the elements of patriarchy and collectivism, as well as family and other connections are particularly strong, the consequence at the local government level is a relatively strong unity of employees in the opposition to the layoffs of redundant workers.

***While the performances of the utility companies have been improved over the last ten years or so, their losses are still high, and as a consequence of that, the local budgets provide considerable levels of subsidies to cover for losses.*** The overall direct subsidies provided from the local budgets to the utility companies in Serbia in 2010 were RSD 25 billion or approximately 0.8 percent of GDP. Moreover, the subsidies are highly concentrated: Belgrade approved RSD 15.5 billion in subsidies to the utility companies (62 percent of the local subsidies), while Novi Sad[111] approved RSD 2.2 billion in subsidies (9 percent of the local subsidies). In accordance with that, these two cities participate with over 70 percent in the direct budget subsidies to municipal enterprises. In addition, municipal enterprises receive indirect subsidies in a form of procurement of gas below the market price. The main causes of such high subsidies are low prices of services (the prices of public transportation in Belgrade and the prices of heating in a large number of local governments are below cost recovery), and high operating costs (employment surplus, procurement of products above the market price, etc.). In addition, the Vojvodina budget approves RSD 4 billion in subsidies, so that the overall subsidies at the sub-national level (local and mid-government levels) are approximately 1 percent of GDP.

In 2011, the local government level realized investments in the total value of approximately RSD 48 billion or 1.5 percent of GDP, while the expenditures for the procurement of goods and services were approximately RSD 49 billion or 1.5 percent of GDP presented in Graph 10.2. Therefore, the overall expenditures of local governments for the acquisition of current and capital assets were RSD 97 billion or nearly 3 percent of GDP. While there are no systematic assessments available to allow for a more accurate assessment of the losses due to excessive costs of procurement of goods and services and investment costs, in most local governments there is anecdotal evidence that points to large irrationalities.[112]

***The efficiency of the local governments does not depend only on the costs but also on the service quality and access to services that are under their competence.*** In contrast to the direct budget expenditures that can be precisely measured, similarly to the central government performance assessment, the local government performance assessment is much more complicated. In some cases it is relatively difficult to measure the quality of services (e.g. the quality of special planning, the value of the attractiveness of a bridge, park, sport venue or a library), while in other cases the quality of services can be measured relatively precisely (e.g. number of days required to obtain a construction permit, a share of taxable

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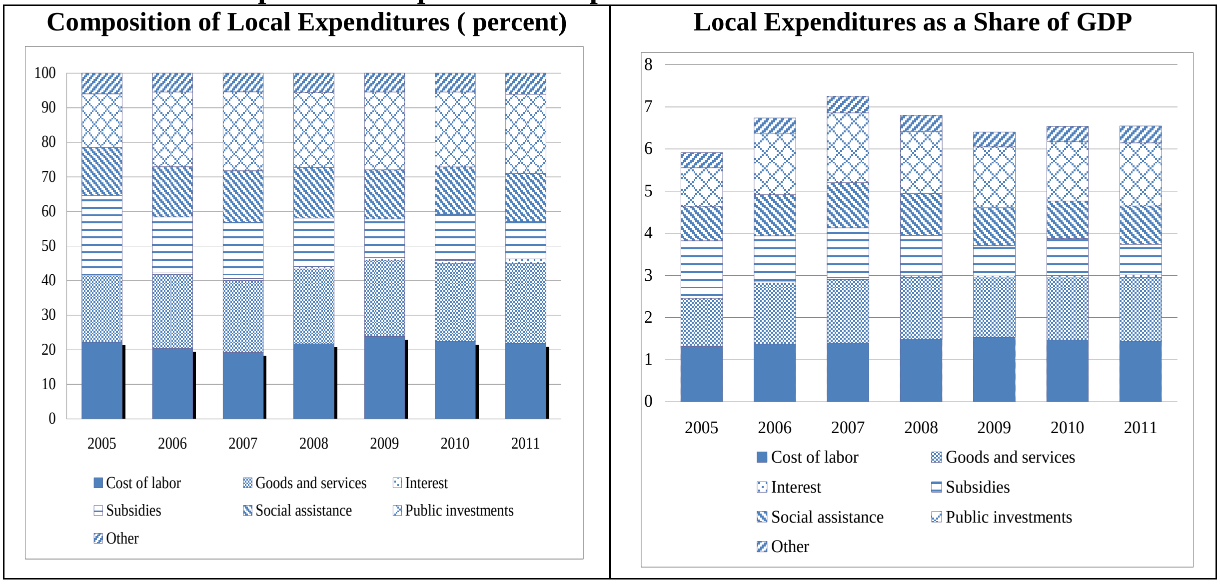
[111] It is interesting that other cities of similar size as Novi Sad approve considerably lower subsidies: e.g. Nis approves 340 million dinars, and Kragujevac approves 370 million dinars. In respect to Belgrade, high subsidies for transportation can be justified by a large territory of the city, but it is indisputable that in the future there has to be a gradual increase of the prices and the reduction of the costs to create room for the reduction of subsidies.

[112] The examples include streets asphalted every two to three years and the construction of sport venues or parks that after a year of two already show the signs of dilapidation. In addition to that, the materials for the current work of local governments are often procured considerably above the market price, etc. Naturally, in the lack of an adequate system, the irrationalities depend primarily on the local leaders, and that is why there are significant discrepancies in terms of efficiency from one local government to the other.

assts). However, even in cases when the local government efficiency can be precisely quantified (e.g. issuance of construction permits), it is very difficult to estimate the overall the resulting economic and fiscal losses.

**Graph 10.2 Composition of Expenditures of Local Governments**




Source: Ministry of Finance

One of the main typical functions of local governments is establishing and maintaining order in urban planning, which implies timely adoption of and compliance with urban plans, as well as fast and efficient construction permitting. The efficiency of the performance of the above functions is very low, which increases operating costs and risks of doing business in Serbia, reducing the value of the property of Serbian citizens, and indicating corruption and/or incompetence of local authorities.

***In the previous decade, most local governments have not made any progress in establishing the order in urban planning, and as a result of that unplanned and illegal construction are still very widespread.*** The lack of urban plan order will have long-term negative consequences on the living conditions of the population, as it obstructs the construction of utility infrastructure and modern road network, burdens the electrical power network, prevents development of parks, undermines the city esthetics, etc. The perseverance of illegal construction in spite of the fact that the municipalities and cities have the human and technical capacities to prevent it indicates a worrying level of corruption in this area.[113] The unplanned construction reduces the value of properties, which are an important part of the national wealth, and has a long-term negative impact on the property tax revenue.

The construction permitting is linked closely to investments, and the delays in the permitting process represent a sort of a cost that investors have to take into account when selecting a location for investing. In accordance with the World Economic Forum and the World Bank surveys, in terms of the speed of construction permitting, Serbia is among the lowest-ranked countries in the world. While the responsibility for lengthy procedures probably lies on the central government, which is responsible for the legal regulation in this

[113] The urban regulation in the villages in Vojvodina, which were built some 200-300 years ago, proves that the urban plan order can be established even with modest techniques, provided that the administration is well-organized and uncorrupted.

area, for the biggest part, the responsibility lies on the local governments, which is indirectly proven by examples of local governments that which approve permits in a very short time and comply with the existing regulations. The slow issuance of construction permits immediately impacts the decline in investments, decreases employment and slows down the economic growth. It also results in the reduction of the overall local and central government tax collection.

***In the course of the previous decade, there has been a notable improvement of the state of utility infrastructure, which dilapidated during the 1990s, when there were practically no investments in recurrent and capital maintenance.*** Even though the general trend of improvement is undisputable, the progress very much varies from one local government to another. While some local governments show considerable progress, the situation in others does not improve, which suggests the presence of serious indications of corruption and/or incompetence of some local authorities. In addition to that some utility infrastructure segments, such as wastewater treatment and waste processing, in Serbia are still at the initial stage of development.

The tax system[114] at the local level generates large distortions[115], which poses a burden especially for micro and small enterprises, and as a result of which a large number of micro and small enterprises closed business or moved into the informal sector. Some of the key distortions at the local level include underused potentials for property taxation, with a presence of arbitrary and economically unjustified differences in the taxation of different types of property. While a significant portion of properties is not taxed at all, the tax burden borne by another portion of properties is very high (the sum of property tax and fees for use of urban construction land). A high percentage of untaxed properties points to the inefficiency of the local tax administration. In addition, most local governments, as a response to the reduction of the transfers from the central level, increased local taxes and fees, whose levels are not proportional to the capacities of the taxpayers, which is probably one of the key reasons for closing small business and shops during the time of crisis.

Based on the above, it can be concluded that even before the onset of the economic crisis there were serious problems with the efficiency of local governments, and that the level and quality of their services could not justify the resources they spent. A part of the irrationalities in local governments is a consequence of the fiscal decentralization not followed by the necessary political decentralization. In countries with a generally low quality of the state authorities' services, as a rule, the quality of services at the local level is even lower. In addition, the irrationality in the provision of specific local services (construction permitting, wild constructions, failure to tax property) indicates the presence of corruption. The additional risk of reinforcement of the existing and creation of new irrationalities at the local level is caused by the provisions of the Law on Financing of Local Government, based on which the local governments received considerably higher revenues, without any new obligations delegated to them.

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[114] The term "tax system" is used in the broadest possible sense and it includes also quasi-fiscal duties.

[115] Distortions mean that the taxpayer costs created in tax system exceed the benefits for the state. Distortions are present when the same level of budget revenues can be generated with a different tax structure (excluding the classical flat-rate tax types), while reducing the loss of taxpayer welfare.

### 10.2. Short-term Measures for the Development of Fiscally Sustainable Fiscal Decentralization Concept

The short-term measures would be implemented in a period 2012–2013, and their main objective is to eliminate the vertical imbalance in the reallocation of revenue and expenditures between the central government and the local governments and improve the financial position of the local budgets, through reducing of arrears and deficit. The implementation of the short-term measures would be a precondition for the fiscal decentralization of the state, but also a sound basis for a fiscally sustainable increase of the local governments' competencies and the improvement of their efficiency.

*10.2.1. Measures in 2012*

The short-term measures apply to 2012, for which it is expected that the existing system for the allocation of taxes and division of functions between the central level and the local governments will still be effective. The main objectives of the short-term measures are: a) to prevent permanently the economically unjustified increases in local expenditures, and b) to use the temporary surplus of revenue over expenditures to improve the financial position of local governments.

The major risk of a permanent and economically unjustified increase in the local governments' expenditures is a high probability that the increased revenues would be used for:

- wage increase, or
- employment increase.

Past experience shows that these risks are not negligible. That is why it is necessary that the Government adopts the relevant regulations to prevent that. Any wage increase by the local governments would increase already big difference that exists between the public sector and the private sector wages, which would encourage the requests of the employees at the central level for a wage increase to maintain parity with the local governments. If the wages are increased above the level specified by the fiscal rules anyway, an intervention by the central level will be necessary to bring the wages back within the statutory framework. An employment increase in the local governments would be sanctioned by the central level by reducing the transfers, and disclosing the information about it.

That is why it is recommended that the local governments should use the temporary surplus of revenue over expenditures in 2012 as follows:

- to reduce arrears, which were accumulated especially in the period 2009–2010, when the local governments were deprived for their transfers. The payment for obligations for the cumulative arrears of the local governments and municipal enterprises would be of a one-off payment nature and would not result in the increase in fiscal deficit;
- those local governments that do not have arrears could use the temporary surplus of revenue over expenditures to reduce their deficit, if any, or for generating surplus. Reducing deficit or generating surplus at the local level could contribute to a certain extent to the reduction of the consolidated government deficit in 2012, which is notably above target, in accordance with the data for the first quarter (see Chapter 1);
- such reallocation of spending that would imply that the local governments that do not have a fiscal deficit and a high public debt could use the temporary surplus funds to increase investments.

The use of the temporary surplus funds of the local governments for financing of reduction of arrears and debts and increased investments could have significant positive macroeconomic impacts on the Serbian economy. Reducing arrears and debts of local governments and their enterprises would result in the reduced illiquidity of the economy, promoting indirectly economic activity, while the increase in the local investments would directly result in the increased economic activity. That is why it is necessary that the central level supervises the use of funds and enforces strictly the statutory powers to prevent unlawful conduct by the local governments. That includes the immediate application of the statutory rules on the movement of public sector wages, but also the effective use of the transfer policy to discourage economically irrational use of funds at the local level.

*10.2.2. Development of Fiscally Sustainable Fiscal Decentralization Concept*

In Chapter 1 it was shown that the prevention of the public debt crisis in Serbia requires an urgent and considerable reduction of fiscal deficit. The elimination of the structural fiscal deficit created as a result of the Law on Financing of Local Government is one of the key fiscal decentralization measures.

The reduction of fiscal deficit created on that account – can be achieved in two economically sustainable ways:

- the first way is to change the payroll tax sharing model by increasing the share of the central government and reducing the share of local governments;
- the second way is to devolve certain functions from the central level to the local governments.

***From the aspect of public finance, the best solution is to annul the amendments to the Law on Financing of Local Government that became effective at the end of 2011.*** That would eliminate the vertical imbalance in the allocation of taxes and competencies, creating a good basis for the reform of personal income tax, as well as a platform for the improvement of the transfer system. That would imply returning the share of the central government in the payroll tax back to 60 percent, while the local governments would have 40 percent. Parallel with that, [the transfers] from the central level to local governments would be increased by approximately 0.8 percent of GDP[116], in accordance with the previous transfer model. Abolishing of the amendments to the Law on Financing of Local Government would not have a particularly negative impact on the credibility of the county, as the tax sharing pertains only to various levels of government, while the tax payers would still pay the same levels of obligations In relation to the consolidate general government sector, the local governments would be brought back to the position in which they were in the pre-crisis period, i.e. 2006–2008, when they received 40 percent of the payroll tax, but also the transfers at the level of 1.7 percent of GDP.

***The second way to eliminate the deficit created as a result of the Law on Financing of Local Government is to devolve certain functions from the central level to the local governments, while maintaining the current payroll tax sharing model and the current transfer system.*** In that case, it would be necessary to devolve obligations at the level of approximately RSD 25 billion from the central level to the local governments. That would solve the problem of the vertical imbalance of tax and revenue, but the current discretionary

[116] The increase of transfers by 0.8 percent of GDP includes strict application of the laws from the period 2007–2008 (0.5 percent of GDP), increased the local road maintenance costs (0.3 percent of GDP).

transfer system would be retained, while the payroll tax would essentially continue to be a local tax.

If the second option, i.e. the devolution of functions from the central to the local government level, is selected, the implementation should be designed so as not to decrease the efficiency of the state overall. That is why it is considered that it would be best that the devolution of functions from the central to the local government level is implemented by making the local governments participate with a certain percent in the financing of social welfare and/or wages for employees in elementary schools and high schools. Such devolution of functions would not require extensive preparations, which would be required, for example, in case of the devolution of an important function from the central to the local level.

***Based on the comparison of the above two options, the Fiscal Council finds that the first option is economically superior, as it would eliminate the vertical fiscal imbalance, which would result directly in the decrease of the consolidated general government deficit.*** In addition to that, the payroll tax would become a dominantly central government tax, which is a more favorable basis for its reform in the future – e.g. for increasing its progressivity rate. The transfer system would be returned to period 2006–2008, which would be a good starting point for further improvements of the current improvised transfer system.

In addition to the above two options, which are considered economically sustainable, there are other proposals that are discussed in the public arena, which the Fiscal Council finds economically unsustainable. One of such proposals is to introduce new functions at the local level, rather than have the local governments take over some of the functions from the central level. This proposal implies either an increase in the consolidated public spending and structural fiscal deficit by 0.6-0.7 percent of GDP, additional reduction of public expenditures or an increase in revenues at the central level by 0.6-0.7 percent of GDP relative to the proposals in Chapter 1.

## 10.3. Fiscal Decentralization in the Medium to Long Term

The main objective of fiscal decentralization in the medium term is the improvement of the efficiency of local governments in their performance of the current competencies, as well as a gradual and fiscally sustainable devolution of competencies from the central to the local government level. In the long term (over five years), in addition to further strengthening of the local governments' competencies, fiscal decentralization would include a gradual and selective devolution of competences to the mid-government level, i.e. to the regions.

### *10.3.1. Short-term Measures for Improvement of Local Governments' Efficiency*

The main objective of the short-term measures for the improvement of the local governments' efficiency, implying an increase of the volume and quality of their services while minimizing their costs. The implementation of these measures would have a positive impact on: the stats of the local budgets and the consolidated government budget, the improvement of the quality of local services and the improvement of the business environment. The largest part of these reforms could be implemented in the period 2013–2016, and would include both local government level and the municipal public enterprises.

***The measures aiming to increase the local governments' efficiency could be divided tentatively into three groups, depending on their dominant impacts.*** The main objective of the first group of measures is to achieve a direct impact on the improvement of the status of the local budgets, the main objective the second group is to improve the efficiency of the local government, while that of the third group is to achieve an impact on the improvement of the business environment. The above division is very tentative, considering that the measures improving business would at the same time influence the increase of the local taxes in the future, while the measures improving the efficiency of local services will at the same time have a positive impact on the business environment and the local budgets.

1) The direct measures for improvement of the state of local budgets include:

- reducing the number of redundant employees,
- reducing subsidies to local public enterprises,
- improving cost-efficiency of public investments and procurement of goods and services, and
- restitution of the local governments' property.

***The reduction of the number of redundant employees in the local governments, the reduction of subsidies to utility companies, and the improvement of the cost-efficiency of the current and capital procurements directly result in the reduction of expenditures and the improvement of the status of the local budgets.*** It is estimated that in the medium term is it possible to achieve saving on the above bases at the level of nearly 1 percent of GDP, without undermining the current quality and volume of services. More than one half of the above savings would be achieved by the reduction of the local subsidies.

The estimated employment surplus at the local level is six to eight thousand employees. In case the employment surplus is fully eliminated, the number of employees in the government sector would be reduced by 1.5 percent. The overall savings in that case would be approximately RSD 6 billion or approximately 0.2 percent of GDP. In order to be able to control operating costs, the central level should ensure a strict enforcement of the wage indexation rules at all levels of government, including the local level. In reducing the employment surplus at the local level, the central government is in a sensitive position, as it has the obligation to promote the efficiency of the local governments, while leaving enough room for their independence. The central government's influence on the reduction of the employment surplus in cities and municipalities could be ensured through a more efficient use of transfer policy, as well as through the promotion of competition between local governments.

From the aspect of the local public finance, it is important to reduce gradually the subsidies to utility companies, without undermining the quality of and access to their services. The subsidies to municipal enterprises are currently RSD 25 billion (0.8 percent of GDP) and a feasible target could be to halve their share in GDP in the period 2013–2016. Considering that over 70 percent of local subsidies is provided from the budgets of Belgrade and Novi Sad, the largest reduction subsidies needs to be achieved in the above cities. A similar target could be set also for Vojvodina. If the subsidies at the level of cities, municipalities, and Vojvodina are halved, by 2016, the savings could be achieved at the level of approximately 0.5 percent of GDP.

The reduction of subsidies to municipal public enterprises requires a reduction of operating costs of the utility companies, such as: reducing the number of redundant employees, adjusting the employee wages with the private sector wages, improving public procurement policy, etc. However, in some cases it is not possible to reduce the losses of the public enterprises or the subsidies for financing of such losses if the prices of the utility services are not increased.

It is estimated that the rationalization of the procurement of goods and services and local investments could result in savings at the level of 5 percent to 10 percent, with maintaining the volume and quality of local services at the current level. That means that the elimination of non-productive spending, which is almost certainly connected to corruption and/or incompetence of local authorities, would result in savings at the level of RSD 5-10 billion.

The adoption of the Constitution and the Law on Public Ownership ensured the legal conditions for the restitution of property to local governments. For the economic impacts of this measure to be visible, the local property has to be transferred legally and in terms of accounting from the central level to the local governments as soon as possible. While the independence of local governments will be increased after they get their own property, that will not influence significantly their revenues, considering that the most local governments generated revenue on that basis even in the past (urban construction land fees, leasing, etc.). However, the local governments will now be able to use a part of their property for securing mortgages or to dispose of surplus local property. Clear ownership relations will encourage increased investments in the urban construction land, and in addition to that, it will contribute to the improvement of local taxed though the segregation of the property taxes and fees. Clear segregation of ownership relations between the central level and the local governments should contribute also to a more rational use and improved maintenance of local property.

2) The measures for improvement of local governments' efficiency include:

- strengthening competition between local governments,
- more active use of the transfer policy, and
- political decentralization.

***Ensuring the conditions for the competition between local governments can often contribute to their increased efficiency.***[117] Examples of successful local governments that succeeded in attracting a large number of investors, improved their local infrastructure, administrative services, etc. serve as an incentive to other local governments to follow their example. The voters in a local government will likely support a policy that has proven successful in other local governments. However, the citizens/voters often do not have access to all the information necessary to evaluate the efficiency of the local authorities. That is why it is necessary to establish databases at the central level based on which indicators could be developed to enable the citizens in an easily comprehensible and accessible way to compare the efficiency of the authorities in their municipality/city with that in other municipalities/cities. The indicators, which would be available online, would help the voters to evaluate the quality of the local authorities as objectively as possible, which would create a strong competitive pressure for the improvement of their performance.

The central level already has a possibility to use the transfer policy to promote local governments to adopt economically rational and socially responsible behavior. Failed attempts to reduce the employment surplus at the local level during the current crisis, slow increase of the tax coverage of properties, as well as the failure to collect regularly the local level financial data are just some examples of inadequate influence of the central government on the local authorities. In order to increase that influence, it is necessary to stipulate by law the conditions for the reduction of transfers to those local governments that use the resources to a considerable extent irrationally, as well as the immediate statutory responsibility of the local title holders who ignore the requests from the central level.

Political decentralization is one of the factors that can have a positive impact on the efficiency of fiscal decentralization. Political decentralization implies primarily direct elections of municipality and city mayors, which strengthens their direct responsibility to the voters. Also, there are some indications that any considerable fiscal decentralization should be

[117] Naturally, that does not always have to be the case, as the tax competition between the local governments results in the decreased revenues of all the local communities, without achieving the desired effects in terms of attracting investments, increasing employment, etc.

preceded by political decentralization. For political decentralization to have a positive impact on the efficiency of local services, it is necessary that it is supported by the competition between local governments.

3) Measures for improvement of business environment include:

- reducing administrative barriers and corruption, and
- improving the tax system at the local level.

Reducing the time it takes to obtain a construction permit requires the reconsideration of the legal provisions and strengthening of controls, to investigate whether a prolonged permitting procedure is a way of extorting bribes from the investors. The disclosure of the comparable data by municipalities and cities would also contribute to put the pressure on the local governments that are lagging behind in terms of the permitting times.

The main objective of the tax reform at the local level is to reduce the distortions created in the existing tax system. That could be achieved by reducing, integrating or abolishing some quasi-fiscal duties, while increasing the balance significance of property tax.

*10.3.2. Increasing Competencies of Local Governments and Regions*

***From the economic point of view, decentralization is an instrument for the improvement of the efficiency of public services.*** From the political point of view, decentralization may be used as an instrument for increasing democracy, as the decisions on taxes and the use of public funds are brought closer to the general public. While the political criteria are important in the decision-making on decentralization, it is certain that decisions that diverge considerably from the economic efficiency principles cannot be sustainable (which, for example, do not comply with the economy of scale principles or which result in inadequate supply of national public goods).

***The international practice in terms of fiscal decentralization is very heterogeneous and depends to a large extent on the tradition.***[118] There are considerable variations between countries in terms of the competencies that long to municipalities and cities. In respect to the mid-government competencies (federal states, republics, cantons, provinces, districts, counties, etc.), the variations are even larger and in this case the influence of the historical heritage is even stronger. While in some countries the mid-government level has considerable competencies, in other countries, their competencies are symbolic.

The share of local and mid-government (regional) expenditures in the EU countries, which do not have officially a federal status, on average, is 13.7 percent of GDP or 27 percent of their consolidated expenditures. In the ten new EU members, the share of local governments and regions in GDP is 10.7 percent of GDP or 24.4 percent of consolidated expenditures. However, the share of local governments and regions in consolidated expenditures varies in a broad interval from 4.7 percent of expenditures in Cyprus to 64.7 percent of expenditures in Denmark (see Attachment 10.1). The variability of the share of local governments and regions in consolidated expenditures (variation coefficient: 0.54) exceeds by far the variability of the share of consolidated expenditures in GDP (variation coefficient: 0.13).

[118] Maximum level of fiscal decentralization is not optimal from either economic or political aspect, which is best illustrated by examples close to us. Former SFRY was the most decentralized country in the world, in which the federal budget was 4-5 percent of GDP, while, for example, the Swiss confederation budget is 12-13 percent of GDP. Currently, Bosnia and Herzegovina is the most decentralized country in the world, but it cannot be taken as an example of efficient state organization either.

***In accordance with international comparisons, but also based on the tradition in Serbia, it is almost certain that in the future the competencies of the local government should be increased.*** The share of local governments in consolidated expenditures in Serbia is still lower than that in the EU members and the countries in the region. In Serbia, the share of local governments in consolidated expenditures in the pre-crisis period was 15.6 percent or 7 percent of GDP, while in 2012, it will be 17.6 percent or 7.6 percent of GDP. The sub-national government (local level plus Vojvodina) participated, in the pre-crisis period 2007–2008, in consolidated expenditures with 19 percent or with 8.5 percent of GDP.

During the previous decade, the local governments in Serbia received additional funds for the performance of certain competences (e.g. utilities, pre-school education, urban planning, etc.), which are very much incontestable, as they belong to local governments in almost all countries. However, Serbia is already entering the phase when it has to select the functions to be devolved to the local level. In some countries, the local level competencies include primary and secondary education, while in others it is primary health care, in the third group of countries it is social welfare, in the fourth group it is the police, etc. In strongly decentralized countries (e.g. Scandinavian countries, USA) all or most of the above competencies belong to local governments. In less decentralized countries some of the above competencies belong to local government, some belong to central government, while some functions are co-financed by both the government levels.

Attachment 10.2 provides a comparative overview of the composition of the local level and regional expenditures in Serbia and in EU by functions. It is obvious that the functional composition of expenditures in Serbia is diverging considerably from that in the EU members. The local governments and regions in Serbia allocate a considerably lower percentage of their expenditures for education, social welfare and health care than the EU countries – both old and new. On the other side, the local governments and regions in Serbia allocate considerably more resources for general services (mostly typical administrative functions) and economic functions (subsidies, etc.) than the EU members. The composition of the local level and regional expenditures in EU, but also in other developed countries, could serve as a reference of the direction that should be taken in increasing the competencies of local governments and regions in Serbia. That means that in the future the competencies of local governments in the areas of education, health care and social welfare should be increased. In addition, as a part of the medium-term fiscal consolidation, the share of expenditures for subsidies and general services would be reduced (laying off the redundant employees and equalizing wages with the private sector).

***Increasing the competencies of local governments in the area of secondary education in Serbia could be achieved by including the local governments in the financing of the employee wages with a certain percent, which would be increased over time.*** If the current payroll tax sharing model is maintained, very soon, the local governments could participate with a certain percentage in the financing of employee wages in primary and secondary education. However, the central government would continue to participate in the financing of primary and secondary education indefinitely through transfers, with the main objective to ensure equal access to education in all local governments. In addition to that, the central level could use the transfers to promote the quality of education byway of approving additional transfers to the schools that provide high-quality education or achieve considerable progress. For the quality of education to be adequately evaluated, it would be important to introduce standard tests for all primary schools. Similar tests could be used also in groups of related high schools (grammar schools, economic, law and other high schools). In addition to the financial intervention, the central level would adopt laws to regulate the primary and secondary education standards, which would apply to both the state and public schools.

***In respect to health care, it is possible to transfer to the local governments the financing of a portion of material costs of health care institutions in the area of primary and secondary health care.*** Later it would be possible to transfer also the costs of recurrent and capital maintenance of buildings and equipment to the local governments, while the costs of medical treatment would be financed by the health insurance fund that exists at the central level. In this case too, the central level would have to provide assistance to the poorer local governments particularly for capital maintenance. The financing of clinical centers of national importance would be fully a competence of the central level, while regional clinical centers could be devolved in the future to the regions.

***One of the desired directions of decentralization in Serbia is increasing the obligations of local governments in the financing of social welfare.*** That could be achiever already in the short term, if the current payroll tax sharing model is maintained. A larger role of the local governments in the administration and financing of social welfare could contribute to improving its efficiency, considering that socially vulnerable persons can be better targeted at the local level. In doing that it is necessary to ensure a higher level of transparency in the social welfare approval process to avoid the risks of abuse in awarding rights to social welfare[119]. However, it is necessary that the central level continues to have an active role in social welfare, and not only as the regulator, but also as a co-financier of social welfare. Considering that social welfare includes a really large number of programs, some types of social welfare (e.g. financing of the rights of disabled war victims) would remain entirely at the central level, while the financing of others types would be transferred to a greater or lesser extent to the local level (financial assistance to families (MOP), child allowance, etc.).

A complete devolution of social welfare functions to the local level is undesirable as it would result in large variations in terms of the social assistance levels and coverage from one local government to the other. Large variations of the social welfare rights are unacceptable from the aspect of equity and equality of citizens[120]. Large social welfare variations between local governments are not sustainable in the long term, as they are subject to certain market mechanisms that decrease them. Namely, generous social welfare programs in some local governments attract the poor population from other local governments, resulting in the end in the reduction of social assistance level per beneficiary. However, leaving the equalization of the social assistance levels in different local governments entirely to the market would lead to high social costs in the short and medium term, and that is why the equalization of the social assistance levels through transfers from the central level is economically and socially justified.

***From the economic point of view, strengthening the competencies of the mid-government level would be justified only under the condition that it contributes to increasing the economic efficiency of the general government.*** That means specifically that it is justified to transfer specific functions to the mid-government level only if they would be performed more efficiently at the regional level than at the central or local levels. That has to be done with a great deal of caution, as the international experience shows that a hasty strengthening of competences at a certain level of governance almost certainly results in increased costs, while the improvement of their performance is uncertain. Based on the above,

[119] It has to be noted that these risks are higher in the societies with a strong collectivistic tradition, and that they are particularly acute in smaller local communities.

[120] A certain level of variations in the social assistance levels is justified due to different cost of living in different local communities. In addition, moderate variations are in accordance with the promotion of competitiveness between local communities.

it can be concluded a hasty strengthening of competences at the mid-government level would more likely decrease the efficiency of the general government than increase it.

That is why it is considered that the transfer of competences from the central or local levels to the mig-government level in Serbia needs to be gradual and selective, as the transfer of a large number of functions to the regions in a short period of time would more likely decrease the efficiency of the state than increase it. A hasty strengthening of competences at the regional level would almost certainly result in increased number of employees in the government sector, duplication of some functions, etc. In addition, considering that the regions, at least at the initial stage, could provide services to the local governments in their territory, one of the possible solutions is to finance them from the contributions by cities and municipalities in their territory. This model of financing would be a sort of a safeguard against economically unjustified increase in costs at the level of regions. Naturally, that does not exclude the possibility for regions to be given certain exclusive revenue sources in the future, most likely in a form of a share in the existing taxes at the central and local level. Introducing new tax revenues, in a form of surcharges and like at the level of regions would result in a further increase of already high fiscal burden, and is therefore considered unjustified. A relatively low efficiency of the state administration in Serbia is another argument against a hasty transfer of competencies to the regions. In such cases, strengthening the competencies of the regions would further decrease already low efficiency of the general government.

***From the aspect of economic efficiency, the fiscal clustering of several local governments for the purposes of implementing specific projects is desirable.*** Clustering several local governments would achieve economies of scale, reducing the costs of state services. Examples of projects that could be implemented more efficiently at the level of municipal clusters include: construction of regional waters supply networks, waste storage and treatment capacities, river watercourse regulation, local road construction, etc. To encourage municipal clustering for the purpose of the implementation of joint projects, the central government could approve co-financing transfers, which would mean that, for example, for every 100 dinars provided by the municipal cluster the central government would provide 10 dinars from their resources. Functional municipal clustering is not an alternative for regionalization, but more of a complement to regionalization. While municipal clustering has been a possibility even before now, such projects have rarely been implemented, probably due to the strategic behavior of municipalities and cities that tried to push over as much costs as possible to the other partners, while taking as much benefit as possible for themselves – if everyone acts is this way, there can be no project implementation. The co-financing transfers from the central government would reduce the project costs for municipalities and cities, which would reduce particular benefits from strategic behavior for municipalities, increasing the probability of joint project implementation.

In addition to economic arguments, there are other arguments that go in favor of a gradual and selective decentralization. They include a relatively small territory of Serbia, which is limiting the justifiability of a stronger regionalization. In contrast to local governments, in the modern Serbia, with the exception of Vojvodina, there is no tradition of the mid-government level. Even though the mid-government level did exist in different forms, their competencies, except in the case of Vojvodina, were limited.

**Attachment 10.1 Consolidated and Local Public Expenditures, 2009**

| | Public expenditures (percent of GDP) | Local expenditures* (percent of GDP) | Local/overall expenditures (percent) |
|---|---|---|---|
| EU-27 | 50.6 | 13.7 | 27.0 |
| EU-10 | 43.4 | 10.7 | 24.4 |
| SERBIA | 46.0 | 8.1 (9.2) | 16.7 (20.8) |
| Austria | 52.5 | 8.2 | 15.6 |
| Belgium | 52.9 | 7.1 | 13.4 |
| Bulgaria | 38.1 | 6.9 | 18.1 |
| Cyprus | 46.4 | 2.2 | 4.7 |
| Czech Republic | 44.1 | 11.9 | 27.0 |
| Denmark | 58.5 | 37.6 | 64.3 |
| Estonia | 40.6 | 10.0 | 24.6 |
| Finland | 55.3 | 22.5 | 40.7 |
| France | 56.6 | 11.8 | 20.8 |
| Germany | 47.9 | 8.0 | 16.7 |
| Greece | 50.2 | 2.8 | 5.6 |
| Hungary | 49.5 | 12.7 | 25.7 |
| Ireland | 66.8 | 6.9 | 10.3 |
| Italy | 50.3 | 15.7 | 31.2 |
| Latvia | 44.4 | 11.4 | 25.7 |
| Lithuania | 40.9 | 11.3 | 27.6 |
| Luxembourg | 42.5 | 5.3 | 12.5 |
| Malta | 42.9 | 0.7 | 1.6 |
| Netherlands | 51.2 | 17.2 | 33.6 |
| Poland | 45.4 | 15.0 | 33.0 |
| Portugal | 51.4 | 7.2 | 14.0 |
| Romania | 40.9 | 9.8 | 24.0 |
| Slovakia | 40.0 | 7.3 | 18.3 |
| Slovenia | 50.1 | 10.2 | 20.4 |
| Spain | 45.6 | 24.5 | 53.7 |
| Sweden | 52.9 | 25.5 | 48.2 |
| UK | 50.4 | 14.0 | 27.8 |
| Variation coefficient | 0.13 | 0.59 | 0.54 |

* In accordance with CEMR-Dexia classification, the mid-government level exists only in the officially federal states: Austria, Belgium, and Germany. That is why the expenditures of the Spanish provinces (Catalonia, Baskia), which have a high level of autonomy, are treated as local expenditures. In accordance with other sources, the Spanish provinces spend 15.5 percent of GDP, which means that the local level spends less than 10 percent of GDP. Similarly, the mid-government/regional level expenditures (districts, counties, etc.) in other countries are treated as local expenditures. To ensure comparability of methodology, the Vojvodina expenditures have been added to the local government expenditures.

Source: CCRE-CEMR Dexia, *EU Sub-national governments: 2010 key figures*

**Attachment 10.2 Structure of Expenditures at Sub-national Government Level, 2009 (percent)**

| | Education | Social Welfare | General Services | Healthcare | Economic Affairs | Other |
|---|---|---|---|---|---|---|
| EU-27 | 19.4 | 18.7 | 14.0 | 15.5 | 11.9 | 20.5 |
| EU-10 | **33.0** | **9.9** | **12.4** | **9.6** | **14.3** | **20.6** |
| SERBIA | 10.4 | 6.9 | 23.9 | 0.8 | 20.4 | 26.8 |
| Austria | 17.5 | 19.1 | 17.2 | 17.5 | 12.9 | 15.8 |
| Belgium | 19.3 | 16.8 | 23.6 | 2.6 | 9.6 | 28.1 |
| Bulgaria | 29.7 | 6.8 | 20.0 | 4.9 | 10.9 | 27.8 |
| Cyprus | 0.0 | 0.0 | 43.7 | 0.0 | 0.0 | 56.3 |
| Czech Republic | 28.9 | 11.3 | 11.6 | 2.3 | 23.3 | 22.6 |
| Denmark | 10.8 | 54.2 | 4.2 | 23.2 | 3.3 | 4.2 |
| Estonia | 37.9 | 7.4 | 7.9 | 15.0 | 17.8 | 14.0 |
| Finland | 18.7 | 24.4 | 14.6 | 29.1 | 6.2 | 7.0 |
| France | 16.5 | 16.7 | 18.7 | 1.1 | 12.4 | 34.7 |
| Germany | 16.8 | 32.8 | 16.0 | 1.6 | 11.3 | 21.5 |
| Greece | 2.4 | 11.1 | 39.5 | 0.0 | 20.2 | 26.8 |
| Hungary | 28.3 | 13.2 | 17.7 | 13.6 | 8.1 | 19.1 |
| Ireland | 16.1 | 9.4 | 3.6 | 0.0 | 26.3 | 44.7 |
| Italy | 8.1 | 4.7 | 15.7 | 44.2 | 13.9 | 13.4 |
| Latvia | 37.4 | 6.9 | 10.2 | 11.4 | 16.9 | 17.3 |
| Lithuania | 41.0 | 8.3 | 6.5 | 20.2 | 5.0 | 19.1 |
| Luxembourg | 21.4 | 4.4 | 22.0 | 0.1 | 16.1 | 36.0 |
| Malta | 0.0 | 0.0 | 52.2 | 0.0 | 15.5 | 32.3 |
| Netherlands | 28.4 | 13.8 | 16.0 | 1.6 | 16.8 | 23.4 |
| Poland | 26.6 | 11.5 | 9.2 | 16.0 | 16.1 | 20.5 |
| Portugal | 9.7 | 6.4 | 31.7 | 5.3 | 19.0 | 28.0 |
| Romania | 25.6 | 17.3 | 12.4 | 2.1 | 18.8 | 23.9 |
| Slovakia | 39.4 | 7.2 | 17.6 | 0.4 | 13.6 | 21.0 |
| Slovenia | 35.5 | 9.0 | 11.1 | 10.4 | 12.9 | 21.0 |
| Spain | 19.9 | 6.9 | 15.9 | 25.8 | 13.5 | 18.0 |
| Sweden | 21.2 | 26.5 | 11.1 | 27.2 | 6.1 | 7.9 |
| UK | 32.5 | 28.5 | 5.7 | 0.0 | 8.6 | 24.8 |
| Variation coefficient | 0.61 | 0.62 | 0.85 | 0.76 | 0.51 | 0.54 |

Source: CCRE-CEMR Dexia, *EU Sub-national governments: 2010 key figures*

# 11. OWN-SOURCE REVENUES OF BUDGET BENEFICIARIES AND EXTRA-BUDGETARY FUNDS

**Recent Developments and Issues**

Around 160 institutions and agencies in Serbia have their own-source revenues by sale of goods and services as well as collection of fees, license and permission fees, charges for approvals, etc. According to the Fiscal Council's assessment, own-source revenues amount to around RSD 100 billion in 2012. It is common that own-source revenues are at the disposal of budget beneficiaries, so these revenues are part of the budget revenues only in exceptional cases. The total expenses financed from own-source and other additional revenues have been almost doubled in past four years and the most of it is spent on goods and services, then to subsidies, wages and capital investments.

**Proposed Measures**

1. Development of an overall record of all budget beneficiaries and extra-budgetary funds mainly financed from fiscal and quasi-fiscal revenues enabling better monitoring of their revenues and expenses and centralized liquidity management. More transparent own-source revenues of budget beneficiaries in the budget.
2. Integrate revenues and expenses of all budget beneficiaries into the Serbia's consolidated account.
3. Integrate a significant portion of fiscal and quasi-fiscal revenues of budget beneficiaries and extra-budgetary funds into the budget as general budget revenues in the first stage and then reduce expenditures of those budget beneficiaries.
4. Generate savings through consolidation of institutions i.e. dissolve unnecessary budget beneficiaries and extra-budgetary funds or merge them with line ministries in the second stage.

**Expected Results**

It is possible to generate savings in public procurements (goods, contracted services, specialized services – around 0.25 percent of GDP in total), moderate savings in subsidies (around 0.03 percent of GDP in total) financed from own revenues while the impact of more rational payment of wages is estimated to around 0.15 percent of GDP. Reallocation of resources of extra-budgetary funds could additionally generate around 0.2 percent of GDP. The overall fiscal impacts of the reform in the area of own-source revenues are estimated to around 0.8 percent of GDP in 2012 and 2013 and to around 1.5 percent of GDP for the overall period (2012–2016).

## 11.1. Recent Developments and Issues

***Significant number of budget beneficiaries was established based on several different laws.*** In accordance with the Budget System Law, public funds beneficiaries are direct and indirect budget beneficiaries. Direct budget beneficiaries are Republic and local level institutions and organizations while indirect beneficiaries, *inter alia*, are institutions in judiciary, mandatory social insurance funds, other institutions established by the Republic and local government. Budget beneficiaries and extra-budgetary funds are government bodies (ministries), bodies within government institutions (agencies, directorates, etc.), public agencies, regulatory bodies, independent government bodies and special legal entities. They are founded based on the Law on Ministries, the Law on Public Agencies, other laws and Government decrees. The Law also defines extra-budgetary funds as legal entities established by the law and financed from specific taxes, earmarked contributions and non-tax revenue.[121]

***Development of an accurate record of budget beneficiaries and extra-budgetary funds and control over them is required.*** A list of direct and indirect budget beneficiaries is set by a separate regulation and published in the Official Gazette of the Republic of Serbia, while it is envisaged that the Republic body in charge of statistics publish a list of budget and extra-budgetary beneficiaries of public funds annually. The list of budget beneficiaries is published in the Official Gazette of the Republic of Serbia, while the list of extra-budgetary beneficiaries is not available i.e. has not been published so far.[122] It is necessary to develop and continuously harmonize centralized records of all budget beneficiaries and extra-budgetary funds.

***Budget beneficiaries and extra-budgetary funds are financed from the budget and from own-source revenues stemming from sale of goods and services.*** While the extra-budgetary funds are financed from particular sources (taxes, contributions and non-tax revenues), budget beneficiaries are financed both from the budget and from their own and other revenues. Own revenues are revenues generated by budget beneficiaries performing business activities i.e. sale of goods and services, collection of fees, license and permit fees, charges for approvals, etc. Additional revenue sources may be grants, borrowings and sale of non-financial assets.

Own revenues of budget beneficiaries and extra-budgetary funds may be divided into three groups:

- Revenues from sale of goods and services,
- Non-tax revenues, and
- Quasi-fiscal revenues.

Revenues from sale of goods and services stem from particular products and services that government bodies provide to users (citizens and businesses). This group covers, for example, revenues of the Ministry of Education and Science and budget beneficiaries under this Ministry (this particularly refers to higher and university education) or revenues of the Statistical Office of the Republic of Serbia. Non-tax revenues cover various fees and charges charged by government bodies for particular services. This group covers, for example, court fees, fees paid to the Directorate for Plant Protection, etc. Quasi-fiscal revenues represent a special group within non-tax revenues and cover payments for which citizens and businesses receive no or disproportionally small service, for example, various fees for use and protection of water and forest, etc.

Out of the total of estimated value of own-source revenues, which will be elaborated below, it is estimated that one third of these revenues stem from sale of goods and services,

[121] Formally, extra-budgetary funds are also funds of mandatory social insurance, elaborated in other chapters of this document.

[122] Based on the list of budget beneficiaries and discussions with representatives of the Ministry of Finance and Treasury, it may be concluded that the annually-published list of budget beneficiaries is not complete.

one third from non-tax revenues and one third from quasi-fiscal revenues.[123] Within the reform framework of the own-source revenue system, it should be taken into consideration that operational characteristics of institutions generating revenues on the market (the first group of own-source revenues) indicate the need to carefully consider how the first group of own-source revenues (stemming from sale of goods and services) shall be treated, since channeling these revenues into the budget without a prior assessment of revenue sources and potential impacts may compromise regular operations of some government institutions. As for the second and third group of own-source revenues, beneficiaries shall pay actual price of services and government bodies shall not use their monopoly position in order to increase their own revenues.

**Table 11.1 Main Characteristics of Budget Beneficiaries and Extra-Budget Funds Generating Their Own-Source Revenues, 2012**

| Number of gov. bodies[1] | Own-source revenues[2] | Expenditures financed from own-source revenues[3] | Type of own-source revenues | Number of employees[4] | Legal framework |
|---|---|---|---|---|---|
| 156 | RSD 100 billion (around 3 percent of GDP) | RSD 85 billion (around 2.7 percent of GDP) | Revenues from sale of goods and services, fees, charges, licenses, permits | 36,000 (around 8 percent of total number of employees in the gov. sector) | - Law on Ministries<br>- Laws determining specific responsibilities of individual ministries (tenths of laws)<br>- Law on Public Agencies<br>- Law on Public Services |

Note:

[1] Estimated number of budget beneficiaries and extra-budgetary funds; in some cases institutional units are aggregated to the highest level; for example, schools and universities are part of the Ministry of Education while courts are part of the Ministry of Justice;

[2] Assessment based on financial plans, execution of budget of beneficiaries and Republic budgets; revenues of all extra-budgetary funds are not included (due to the lack of data)

[3] Planned expenses financed from own and unspent funds in 2012; expenses of all extra-budgetary beneficiaries are not included (due to the lack of data).

[4] Estimated number of employees in government bodies generating own revenues, without employees in the Ministry of interior and the Ministry of defense.

Source: Ministry of Finance, Fiscal Council

[123] Estimation of revenues in the second and third group is based on a survey done by the National Alliance for Local Economic Development („Bridges: system of non-tax and quasi-fiscal forms in the Republic of Serbia“). NALED estimates that non-tax and quasi-fiscal revenues paid to Republic government bodies (including both budget funds and own revenues) amount to 42 percent of total burden at all government levels amounting to around RSD 75 billion. The estimation of the Fiscal Council is based on the fact that the NALED failed to cover all forms of non-tax and quasi-fiscal revenues and that for the purpose of our analysis it is necessary to separate revenues channelled to the budget and own revenues.

The Fiscal Council has conducted its own survey on budget beneficiaries and extra-budgetary funds generating own-source revenues. Main characteristics of the survey are shown in Table 11.1.[124]

**Table 11.2 Five Groups of Government Bodies Generating Own-Source Revenues**

| | I group | II group | III group | IV group | V group |
|---|---|---|---|---|---|
| **Main bodies** | Ministries and administrative bodies | Agencies and similar budget institutions and extra-budgetary funds | Special organizations (offices, etc.) | Government offices, councils and other bodies | Regulatory bodies and independent government bodies |
| **Number of gov. bodies within the group[1]** | 51 | 46 | 18 | 21 | 20 |
| **Number of employees[2]** | 24,000 | 3,000 | 6,500 | 1,500 | 1,000 |
| **Some government bodies within the group (examples)** | - Ministries<br>- Agricultural Land Administration<br>- Tax Administration<br>- Custom Administration<br>- Treasury | - Export Credit and Insurance Agency<br>- Privatization Agency<br>- Environmental Protection Fund | - Geodetic Authority<br>- Statistical Office<br>- Hydro-Meteorological Institute<br>- Security Information Agency | - European Integration Office<br>- Office for Regulatory Reform and Regulatory Impact Assessment<br>- Government Air-carrier | - Republic Agency for Electronic Communication<br>- Republic Broadcasting Agency<br>- Securities Commission<br>- State Audit Institution |
| **Objectives** | Government policy implementation | Efficient performance of development and expert activities of the government administration | Referent organizations in charge of performance of particular expert activities | Performance of activities needed by the Government | Regulatory and supervisory activities |
| **Potential fiscal savings** | - Procurement of goods<br>- Contracted services<br>- Specialized services<br>- Subsidies<br>- Number of employees | - Wages<br>- Public procurements<br>- Contracted services<br>- Specialized services<br>- Rents<br>- Subsidies | - Public procurements<br>- Contracted services<br>- Specialized services<br>- Number of employees | - Public procurements | - Public procurements<br>- Wages |

Note:
[1] Estimates are based on submitted and available data; the number of employees does not cover the employed in the police, army, judiciary and educational sector.[2] Estimates are based on submitted and available data.
Source: Fiscal Council

[124] Data on budget beneficiaries and extra-budgetary funds have been collected from various sources. A request for data was sent to ministries, Treasury and Business Registers Agency on financial operations and number of employees in state bodies. However, data are not complete and there is a particularly accentuated problem with data for extra-budgetary funds.

***All government bodies are split into five groups.*** Aimed at accurate reviewing of government bodies generating own revenues i.e. at estimating potential fiscal impacts based on desired changes in this area, we classified government bodies into five groups (Table 11.2):

I - Ministries and constituent bodies,
II – Agencies and similar institutions established by other laws,
III – Special organizations (various offices and directorates),
IV – Government offices, councils and similar bodies,
V – Regulatory bodies and independent government bodies.

***The objective of this classification is to distinct rights and responsibilities of various government bodies.*** The basis for this classification into five groups is given by the legal regulation (on which basis bodies are established and operate) and various levels of rights, responsibilities and independency in their work (stemming from institutional structure). The classification is approximate to the great extent and some institutions may belong to two or more groups. Furthermore, a classification criterion is not the official name of the institution, but its functions, legal basis and autonomy of the body. The first group consists of institutions directly implementing policies of ministries and the Government; the second group consists of bodies having significant level of autonomy and extra-budgetary funds[125], while the third group covers organizations operations of which are not connected to the main scope of activity of ministries; the fourth group covers a group of bodies within the Government and the fifth includes bodies performing regulatory and supervisory activities in certain areas.[126] The classification into five groups is important for the fiscal consolidation impact assessment, presented below.

***Resources of all government units shall be managed through the consolidated treasury account and within the financial management informational system.*** The Budget System Law sets that funds of direct and indirect budget beneficiaries are kept and deposited on the consolidated treasury account, meaning that resources of extra-budgetary funds may be kept at bank accounts. Furthermore, the Minister may allow budget beneficiaries to open bank accounts for their own-source revenues, provided that over 50 percent of revenues are generated on the market. Therefore, beside the fact that there are no reliable data on budget beneficiaries and extra-budgetary funds, a portion of resources of extra-budgetary funds and budget beneficiaries is outside the consolidated treasury account. Finally, another problem is caused by the fact that even if resources of some institutions are at the consolidated treasury account these are not in the financial management information system, meaning that these resources are not directly managed by the Treasury – they are on the accounts of budget beneficiaries and funds and not available to the Treasury.[127]

***The Budget System Law leaves significant freedom in terms of own-source resources.*** As for the utilization, the Budget System Law enables the Government to regulate terms, conditions and methods for utilization of those revenues stemming from activities performed by budget beneficiaries. It is a common practice that own-source revenues are left available to bodies generating them and that unspent proceeds are transferred to the next fiscal

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[125] Both types of institutions perform particular functions from the scope of work of ministries and have significant level of autonomy compared with institutions included in the first group.

[126] The group covering regulatory bodies include also institutions financed from the budget (such as the Securities Commission, Republic Agency for Electronic Communications and Republic Broadcasting Agency).

[127] See more in „Efficient Management of the Consolidated Treasury Account“, published as a part of the publication *Handbook on Public Finance Analysis* (issued as a part of the National Investment Planning and Implementing Program, sponsored by the European Union).

year. However, the Government is empowered by the law to channel a portion of these funds to general budget revenues, whereas this is not a standard decision and shall be passed apart. It may be concluded that institutional preconditions are established to ensure that own revenues of budget beneficiaries are used as a part of the general budget revenues only in exceptional cases. Such a possibility has been used in practice in the Program of Measures to Sustain the Fiscal Deficit of the Government of the Republic of Serbia (passed on March 29, 2012) when the Government decided to transfer own revenues of seven budget beneficiaries to the general budget revenues.

***Expenditures financed from additional revenues of budget beneficiaries are not transparent in the budget.*** The budget shows just planned annual own-source revenues and expenditures financed from own revenues (Article 1 of the Law on the Budget), but not the unspent funds from previous years, planned borrowings, grants, etc. and it is understood that there will be a balance between these revenues and expenditures (in fact this is not the case). The budget revenues and expenditures data fail to indicate own and other additional revenues and expenditures of budget beneficiaries and then there is a separate budget section on expenditures broken down by chapters and economic classifications showing expenditures financed from additional revenues in a separate column, after budget funds. This way of classification of own and other revenues of budget beneficiaries results in lack of budget transparency and often omission of comprehensive picture of sources and expenditures of budget beneficiaries.

***Additional revenues of budget beneficiaries, beside own revenues generated during a year, are unspent revenues, borrowings, grants, etc.*** Tables 11.3 and 11.4 are aimed at analyzing own-source revenues. They contain total Republic budget expenditures and various additional sources of finance of budget beneficiaries: own-source revenues generated in the particular year, unspent and retained revenues from previous years, expenditures financed from borrowings, expenditures financed from grants and expenditures financed from other sources. Table 11.3 shows actual expenditures in 2009 and 2010 (since we have data on execution available for those years) and Table 11.4 shows planned expenditures for 2011 and 2012 (data from the law on the budget for 2011 and 2012).

**Table 11.3 Actual Expenditures Financed From Additional Revenues of Budget Beneficiaries in 2009 And 2010 (in RSD billion)**

| | 2009 | 2010 |
|---|---|---|
| Expenditures financed from own-source revenues generated during the year | 46.7 | 52.8 |
| Expenditures financed from unspent resources from previous years | 10.1 | 11.2 |
| Expenditures financed from borrowing | 2.9 | 5.3 |
| Expenditures financed from grants | 2.0 | 23.2 |
| Other | 0.3 | 0.9 |
| Total Expenditures financed from additional revenues | 62.0 | 93.4 |
| Percent of Expenditures from additional revenues vs. Expenditures from the budget | 8.7 | 12.1 |

Source: Ministry of Finance

**Table 11.4 Planned Expenditures Financed From Additional Revenues of Budget Beneficiaries in 2011 and 2012 (in RSD billion)**

| | 2011 | 2012 |
|---|---|---|
| Expenditures financed from own-source revenues generated during the year | 69.7 | 71.2 |
| Expenditures financed from unspent resources from previous years | 18.7 | 15.5 |
| Expenditures financed from borrowing | 48.4 | 39.1 |
| Expenditures financed from grants | 17.9 | 9.3 |
| Other | 1.1 | 1.2 |
| Total expenditures financed from additional revenues | 155.7 | 136.3 |
| Percent of expenditures from additional revenues vs. Expenditures from the budget | 18.3 | 15.6 |

Source: Ministry of Finance

***Expenditures financed from own-source and other additional revenues are extremely high and show raising trend.*** Tables 11.3 and 11.4 show high share of expenditures financed from own-source and other additional revenues vs. expenditures financed from the budget; this share also shows a growing trend.[128] Should planned expenditures in 2012 materialize, expenditures financed from own and other additional revenues vs. expenditures financed from the budget in the period 2009-2012 would be almost doubled (increase from 8.7 percent to 15.6 percent of total expenditures from the budget). Moreover, it should be taken into consideration that there is a significant deviation between previously planned expenditures and actual expenditures during the years for which we have available data (2009 and 2010), due to the fact that during a year expenditures financed from borrowing are significantly below the plan. To be more precise: explanation for execution below the planned figures in previous years is a poor realization of capital investments financed from foreign borrowing.[129] In 2012 capital investments financed from own resources (borrowing included) have been planned more realistically. We estimate that considering more realistic plan and realization of previously-contracted loans, realization of investments financed from additional revenues in 2012 departs less from the plan compared to previous years.

***Expenditures from own-source revenues reach RSD 65 billion annually and together with other additional sources, total expenditures not financed from the budget amount to around RSD 105 billion.*** In 2009 and 2010 execution of expenses financed from additional revenues amounted to about 70 percent of planned expenditures due to the abovementioned poor implementation of investment loans. Taking into consideration more realistic budget realization in 2012, we estimate that around 80 percent of planned expenditures financed from additional revenues will be realized during this year, so according to an objective assessment of expenses financed from additional revenues to be realized in

[128] No growth of share in 2012 due to a low level of planned grants for elementary and secondary education and less borrowings planned. Planned expenses from own resources (except unspent revenues, borrowings and other sources) are by 8.5 percent higher in 2012 compared to 2011.

[129] Borrowings from abroad by the Government for capital investments are understood as additional revenues of budget beneficiaries although in those are state borrowings and not borrowings of an individual institution.

2012 will amount to around RSD 105 billion. Out of this amount, we estimate that around RSD 65 billion will stem from own resources that budget beneficiaries generate through sale of goods and services during the year, RSD 30 billion from borrowings and grants and RSD 10 billion from unspent resources from previous years. Should certain below-analyzed risks occur, execution of expenses financed from own-source and other revenues in 2012 could reach even RSD 120 billion, accounting for around 3.5 percent of GDP.

It should be stressed that beside the high value of expenditures financed from additional revenues, budget beneficiaries during a year do not spend all collected resources. Thanks to that, they may accumulate unspent funds and transfer them to the next year in accordance with the Budget System Law. Unspent own funds are used to finance expenses of budget beneficiaries besides allocations they receive from the budget. Executed and planned expenses financed from unspent funds in previous years amounted to some RSD 10-19 billion annually.

***The largest portion of own-source revenues is spent on goods and services, then on subsidies, wages for employees (including various allowances, overtime, standby duty as well as other allowances) and capital investments.*** An important issue in terms of expenditures financed from own-source and other additional revenues is the structure of expenditures financed from these sources (Tables 11.5 and 11.6).

**Table 11.5 Structure of Realized Expenditures Financed From Additional Revenues of Budget Beneficiaries in 2009 And 2010 (RSD billion)**

| | 2009 | 2010 |
|---|---:|---:|
| Expenditures for employees | 13.2 | 24.0 |
| Expenditures for purchase of goods and services | 28.9 | 46.4 |
| *out of which:* | *3.7* | *9.5* |
| *Specialized services* | *12.3* | *14.0* |
| *Contracted services* | *12.8* | *22.9* |
| *Other expenses* | | |
| Subsidies | 4.1 | 5.4 |
| Transfers to other government levels | 1.1 | 2.0 |
| Subsidies to NGOs | 1.1 | 1.2 |
| Other operational expenditures | 2.8 | 2.6 |
| Capital expenditures | 9.7 | 11.3 |
| Expenditures for procurement of financial assets and principal repayment | 1.1 | 0.4 |
| Total expenditures from additional revenues | 62.0 | 93.4 |

Source: Fiscal Council based on the Ministry of Finance data

**Table 11.6 Structure of Planned Expenditures Financed From Additional Revenues of Budget Beneficiaries in 2011 and 2012 (RSD billion)**

| | 2011 | 2012 |
|---|---|---|
| Expenditures for employees | 21.7 | 16.6 |
| Expenditures for purchase of goods and services | 58.2 | 45.7 |
| *out of which:* | *20.0* | *19.4* |
| *Specialized services* | *12.1* | *8.0* |
| *Contracted services* | *26.2* | *18.3* |
| *Other expenditures* | | |
| Subsidies | 8.2 | 18.8 |
| Transfers to other government levels | 3.8 | 5.6 |
| Subsidies to NGOs | 1.8 | 1.2 |
| Other operational expenditures | 13.5 | 7.9 |
| Capital expenditures | 47.6 | 39.3 |
| Expenditures for procurement of financial assets and principal repayment | 0.9 | 1.2 |
| Total expenditures from additional revenues | 155.7 | 136.4 |

Source: Fiscal Council based on the Ministry of Finance data

***Goods and services account for around RSD 50 billion of expenditures financed from own-source revenues.*** In the structure of expenditures of budget beneficiaries from own-source and other additional revenues, purchase of goods and services is the largest item and we estimate that it accounts for one half of the total executed spending financed from additional revenues in 2012, therefore exceeding the planned figures due to the risk that realization within this group of expenditures exceed too restrictive and unrealistically planned fixed costs, material, repair and maintenance costs in 2012. Within the group of expenditures for purchase of goods and services, specialized and contracted services have dominant share. The amount of RSD 27 billion have been planned for these services in 2012, whereas the budget execution in past years was significantly above the plan (by around 30 percent). In this category of specialized and contracted services, there are two predominant budget beneficiaries – Ministry of Education and Science and Environmental Protection Fund for specialized service and institutions within the educational sector for contracted services.

***Dynamic growth of subsidies financed from own-source revenues, especially for the agriculture.*** Beside expenditures for goods and services, subsidies have significant share in the total spending from own-source funds. The execution of this budget category in past years was close to planned figures so we estimate that in 2012 the amount of around RSD 19 billion from own revenues will be paid for subsidies. In 2012 subsidies for the agriculture represents the largest item (through the Administration for Agricultural Land, Budget Water Fund, Agricultural Production Promotion Fund and Veterinary Directorate), amounting to around RSD 15 billion. Beside subsidies from the budget amounting to some RSD 20 billion there is a significant increase in subsidies for the agriculture planned by the aforementioned administrations and funds in 2012 (by some RSD 10 billion) from their own revenues. Out of other significant envisaged subsidies in 2012, RSD 2 billion will be allocated through the Budget Fund for Professional Rehabilitation and Employment Promotion for employment of people with disabilities and RSD 1.4 billion for private enterprises through the Environmental Protection Fund.

***Expenditures for employees stagnate within the structure of overall expenditures, but there is a risk that the execution will exceed the plan.*** In 2012 less expenses for employees financed from own-source revenues has been planned (by several billion) compared to the execution in 2010 and plan for 2011. Similarly to expenditures for goods and services, in the case of expenditures for employees there is a risk that the execution will exceed the plan since there is no visible methodology for this planned significant reduction of these expenditures in 2012 financed from own revenues compared to previous years.

***Capital expenditures are mainly financed from borrowing.*** Capital expenditures, as stated, are planned in such a way that the share in the execution is significantly lower and within the range of expenditures allocated for subsidies and employees (around RSD 15 billion).

## 11.2. Proposed Measures

***Accurate records of budget beneficiaries, comprehensive and strict control of their expenditures and centralized liquidity management are required.*** A group of recommendations refer to managing funds of budget beneficiaries and extra-budgetary funds. Aimed at optimal liquidity management, all resources of all government units shall be managed through the consolidated treasury account and included in the financial management informational system. In order to accomplish this, accurate and unified records of budget beneficiaries and extra-budgetary funds and reallocation of their funds to the consolidated treasury account are required. Proposed activities would result in larger amount of funds available to the Treasury when implementing its liquidity management process hence reducing borrowing of the Treasury on financial market aimed at financing budget beneficiaries.[130]

***Own-source revenues should be shown in the budget more transparently.*** Revenues generated by budget beneficiaries and expenditures financed from those revenues should be incorporated into the budget data. Republic budget transparency is reduced by inadequate indication of sources of own revenues and expenditures financed from those revenues of budget beneficiaries. The most important aggregate budget tables are incomplete because they contain only narrow expenditures of the Republic budget. Namely, they do not contain spending financed from own-source and other additional resources of budget beneficiaries causing nontransparent public finances and economic policy. Interpretation of projected expenditures of some ministries is rendered more difficult, data are even misinterpreted, if expenses financed through administrations, funds and agencies under their jurisdictions are left out. Relying on financing from own-source revenues, certain ministries manage to avoid set thresholds when planning the budget.

*International Experience with Government Institutions Generating Their Own-Source Revenues*

International experience in this area mainly comes from extra-budgetary funds outside control of the central government. Cases of budget beneficiaries generating own-

[130] Actual savings stem from difference between interest rate paid by the Treasury on resources collected on financial markets (around 14 percent) and difference paid by the NBS for resources on the consolidated treasury account (2.5 percent).

source revenues that are not integrated into the general budget revenues are rare.

The general assessment is negative indicating a need to abolish extra-budgetary funds to the greatest extend and incorporate them into the central government level. Problems noticed in their operations refer to lack of transparency in terms of own revenues and expenses financed from those revenues, unsound and inefficient spending, unclear principles, goals and methods of doing business, insufficient coordination with the central budget, too large autonomy and lack of accountability, poor management and even corruption. It is recommended to prepare a comprehensive review of extra-budgetary funds, to include information on them in the law on the budget, forward information to the parliament, set accounting, recording and reporting procedures, internal and external control and audit and appoint the Ministry of Finance to be above extra-budgetary funds in the public finance hierarchy.

There is a positive example in Bulgaria where at the end of `90s 1,200 extra-budgetary accounts were closed and the number of funds was reduced from around 70 to 20. All resources of funds are within the treasury system while the one single law regulates main principle of operations of all funds.

***There are multiple negative impacts of the current concept of own-source revenues.*** Another shortage of the current budget process is the fact that revenues and expenditures of extra-budgetary funds are not public.[131] Their financial plans also lack transparency, since the Budget Law does not provide planned expenditures of institutions not financed from the budget therefore giving an impression that there is a „state within a state“, that there are incentives to set high prices paid by the businesses and citizens for goods and services provided by various budget and extra-budgetary funds without public awareness thereof, and that increasing prices are meant to finance expenditures lacking solid and common legal framework, since business operations of many institutions are regulated by other laws. Inadequate budgeting, reporting and spending of own-source and other additional revenues of budget beneficiaries has several impacts. First, Serbia’s expenditures and deficit may exceed planned threshold despite savings and control at sub-national level, rendering pointless the national fiscal consolidation process. Second, it is impossible to have clear insight into resources available to ministries during a year– only resources from the budget are clearly stated, which is not the case with own-source and other additional revenues of budget beneficiaries (it happens that they exceed budget funds by several times). Third, economic policy being implemented is not clear – public spending structure (in particular subsidies) may be comprehensively reviewed only if own-source revenues are integrated in a budgeting process transparently. Fourth, spending of own-source revenues of budget beneficiaries cannot be monitored during a year reliably considering that from the one hand there is a wide framework for their spending and on the other hand control mechanisms are not reliable (stemming from legal and actual autonomy of budget beneficiaries). Fifth, further violation of the principle of public finance transparency is possible: there are growing incentives to establish new separate budget beneficiaries (funds and agencies) able to provide sufficient resources to finance desired expenditures of line ministries. Sixth, a widespread system of autonomous budget beneficiaries is causing greater quasi-fiscal burden (various fees and charges), therefore increasing burden on businesses and citizens and derogating the Republic fiscal system.

[131] The Fiscal Council collected some data by sending a request to all ministries and other government institutions.

Taking into account previous observations, it is necessary to integrate finances (revenues and expenses) of budget beneficiaries and extra-budgetary funds into the budget process both during budget planning and execution. An important segment of the process is compiling an accurate record of all budget beneficiaries and extra-budgetary funds and continuous monitoring of their operations, impacts and financial flows. It is also important that the Government and the Ministry of Finance as well as the public are informed on operations and financial flows of this widespread government segment.

***A two-phase reform of additional revenues system is needed.*** In the first phase (that should start already in 2012): all resources of budget beneficiaries and extra-budgetary funds shall be held on the consolidated treasury account, a portion of own-source revenues should be transferred to the general budget revenues and achieve savings in expenditures of bodies generating own-source revenues. During the second phase savings should be achieved through institution consolidation i.e. abolishment of unnecessary budget beneficiaries and extra-budgetary funds or their merging with line ministries.

The general objective of the reform of the additional revenues system of budget beneficiaries and extra-budgetary funds is to increase efficiency of government bodies, provide improved services to businesses and citizens along with reduction of pressure to generate savings mainly through increase in taxes and to generate positive impacts on the fiscal consolidation. A successful reform in this area would positively contribute to economic growth and employment.

The text below provides assessment of fiscal impacts of the two-phase reform.

**Phases and Objectives of Reform of Budget Beneficiaries and Own-Source Revenues**

| **Concept of Reform of Budget Beneficiaries and Own-Source Revenues** | |
|---|---|
| **Phase** | **First phase (2012-):** own-source revenues on the treasury account as general budget revenues, reduction of expenditures financed from own-source revenues;<br>**Second phase (2013-)**: consolidation of budget beneficiaries and extra-budgetary funds |
| **Objectives** | **First phase:**<br>increased transparency<br>spending control<br>initial savings<br>reduction of nonproductive expenditures<br>**Second phase:**<br>savings<br>more efficient government administration |

## 11.3. Expected Effects

***During the first stage a significant portion of own-source revenues of budget beneficiaries and extra-budget funds should be directed to the budget as general budget revenues and then spending of those budget beneficiaries should be reduced.*** Formally, such a decision would not require institutional changes and adjustments since the Budget System Law enables the Government to pass decisions on reallocation of own-source revenues (as done at the end of March 2012 with seven budget beneficiaries). However, the Budget System Law should be amended in order to enable reallocations of own-source revenues as a standard and not exceptional procedure. It should be taken into consideration that in that case budget beneficiaries would be left without a portion of revenues to finance their expenses so the budget would be faced with not only higher revenues, but also with need to finance additional expenses.[132] There is a group of bodies having funds outside the consolidated treasury account (in commercial banks), so this proposed solution would imply transfer of resources to the general budget revenues. Groups of government bodies (previously classified in five groups) whose revenues may be transferred to the budget during the first phase are mainly institutions from the first and the second group (ministries, government administration, agencies, funds), and then the third and fifth group (special organizations and regulatory bodies generating own-source revenues). In case of taking over own-source revenues from bodies belonging to the third and fifth group, a detailed assessment is needed considering their autonomy, specific activities and social functions they perform as well as threats to foundations of the government system should *ad hoc* decisions jeopardize operations of regulatory, professional and other bodies from these two groups.

This reform should formally be implemented the next budget year although *de facto* it would be implemented with reallocation of revenues during the first phase. Therefore, simultaneously with transferring a portion of own-source revenues to the general budget revenue category, stronger control of institutions should result in reduction of expenditures currently financed (or financed before reallocation of revenues into the budget) from own-source and additional revenues of budget beneficiaries.

Estimated impact of integration of own-source revenues currently outside the consolidated treasury account to reduction of the fiscal deficit account is some 0.2 percent of GDP.[133] The impact will be permanent, since more funds will flow into the budget from reallocation of own-source revenues vs. the amount of new expenditures stemming from newly assumed obligations. However, it should be taken into consideration that reduction of quasi-fiscal burden would cause also reduction of budget revenues.

Considering five groups of government bodies, savings are feasible in various segments of expenses. Significant savings in public procurements (goods, contracted services, specialized services, etc.) are feasible in the first and second group of government bodies. In some cases, irrational spending by government bodies may be noticed. In some cases those refers to too high renting costs[134], vehicles, IT equipment or cost of equipment maintenance[135], etc. Generally, extremely high expenses for contracted and specialized services in various government bodies are present (in areas of environmental protection, agriculture, education). Through selection of priorities and more rational spending savings should be achieved amounting to some 0.1 percent of GDP.

Moderate savings are possible (around 0.03 percent of GDP) in the area of subsidies financed from own revenues (first and second group of government bodies), having in mind that, besides predominant subsidies for the agriculture, subsidies amounting to some RSD 3.5 billion (plan for 2012) are paid for other purposes.

As for wages for employees, the main savings are possible in the second and fifth group of government bodies (agencies and budget and extra-budgetary funds), since in these groups wages are significantly higher compared to wages in other groups of government bodies. According to available data, in some cases average wages are four times higher compared to the average in the government administration. Even when extreme deviations are

[132] An alternative is to reduce funds received from the budget to beneficiaries that have their own revenues available.

[133] During the first year (2012) the impact depends on speed of adoption and implementation of measures. A full impact could be expected in 2013.

[134] Some agencies rent premises in the centre of Belgrade and pay extremely high renting costs (for example, EUR 15,000 in RSD equivalent amount monthly for agencies with less than 40 employees).

[135] A computer system was purchased for around EUR 50,000 while the following year the same amount was spent for computer system upgrading.

excluded, in largest number of organizations belonging to the second and the fifth group, wages are two times higher compared to wages in government bodies. These differences may be partly explained by higher qualifications (compared to the average qualification of employees in government bodies) in bodies with small number of highly-educated employees. Furthermore, it is the usual practice used by the government bodies to pay overtime, standby duty and other allowances without justified reasons in order to increase wages. When assessing possible saving impacts, one should take into account that the number of some 4,000 employees in these organizations would generate moderate savings even in the case of setting wages at the lower level. A more restrictive approach in the area of expenses for awards for employees financed from own revenues is needed. In 2011, for jubilee and other awards for employees the amount of over RSD 4 billion was spent from own revenues.[136] The overall impact based on rationalization of wages in the aforementioned groups is estimated therefore to some 0.1 percent of GDP.

We estimate overall savings in the first phase of consolidation of own-source revenues (funds currently outside the treasury will go to the budget, reduction of expenditures for procurement of goods and services, subsidies, and wages) to around 0.4 percent of GDP.

***During the second phase savings will be achieved by abolishing and merging of some of the institutions.*** The second phase of the concept of modification of additional revenues of budget beneficiaries implies reviewing effectiveness of budget beneficiaries and extra-budgetary funds. It would be justifiable to abolish numerous institutions, because there is clear overlapping of jurisdictions and functions between various institutions. Some of examples of possible overlapping are:[137] 1) Ministry of Environmental Protection, Mining and Spatial Planning; Environmental Protection Agency; Environmental Protection Fund; Institute for Nature Conservation of Serbia; Serbian Chemicals Agency; 2) Ministry of Agriculture, Trade, Forestry and Water Management; Agricultural Production Promotion Fund; Agrar Payment Administration; Plant Protection Directorate; Forestry Directorate; Budget Forestry Fund of the Republic of Serbia, Budget Hunting Development Fund, Republic Water Directorate; Budget Water Fund; Veterinary Directorate; Agricultural Land Directorate; 3) Ministry of Mining and Energy; Energy Agency; Agency for Energy Efficiency; 4) Ministry of Education and Science; Institute for Improvement of Education; Institute for Education Quality and Evaluation; and 5) PE Nuclear Facilities of Serbia, Vinca Institute, Serbian Radiation Protection and Nuclear Safety Agency. The rationalization implies that simultaneously with abolishment of various institutions, their functions are entrusted to line ministries, therefore avoiding negative impacts of abolishment of institutions in broader terms. On the one hand entrusting ministries with these functions would partially increase their obligations, scope of work and expenses of ministries, but on the other hand visible savings would be achieved in terms of expenses for goods and services, wages, renting[138] as well as other expenses paid by various institutions before being abolished. Potential additional impact in the second phase is estimated to around 0.2 percent of GDP.

Probably there will be some obstacles in implementation of severe cuts in the area of own revenues and autonomy of budget beneficiaries and extra-budget funds. Therefore, we should take into consideration that there are around seventy laws introducing own revenues. Reduction of wages and losing a position to implement autonomous economic measures are

[136] Significant spending on awards (jubilee and other awards) from own revenues was effectuated by the Ministry of Interiors. In 2011 this Ministry paid around RSD 3.5 billion for this purpose.
[137] We listed here ministries, various agencies, funds and other institutions with similar jurisdictions.
[138] It should be considered to use state property more efficiently and to use government premises for operations of various bodies (instead of renting, purchasing or building new premises).

the main reasons for resistance of budget beneficiaries having own revenues in relation to implementation of necessary rationalization measures. An („umbrella“) law is required to regulate operations and operating principles of remaining budget beneficiaries and extra-budget funds and it is also important to define precisely strict formulas and core conditions for potential establishment of new institutions in future.

**Potential Fiscal Impacts of Reform of Own-Source Revenue Concept (percent of GDP)**

| Concept of Reforms of Budget Beneficiaries and Own-Source Revenues | | |
|---|---|---|
| | **First phase (2012-):** | **Second phase (2013-):** |
| | Own-source revenues integrated in the treasury account as general budget revenues, reduction of spending financed from own-source revenues | Consolidation of budget beneficiaries and extra-budgetary funds |
| Inflow of extra-budgetary funds into the budget | 0.2 | |
| Public procurements | 0.1 | 0.15 |
| Subsidies | 0.03 | |
| Expenditures for employees | 0.1 | 0.05 |
| The peak annual impact (in 2013, percent GDP) | 0.6 | |
| Aggregate impact (2012-2016) | 1.5 | |

***Aggregate fiscal impacts of the reform in the area of own-source revenues are estimated to around 0.6 percent of GDP in 2013 and to around 1.5 percent of GDP in the period 2012-2016.*** Fiscal impact of proposed measures will depend on the speed of decision-making and implementation of decisions. In 2012 first-phase savings could be achieved, while the most significant impact can be expected in 2013 (later impact will weaken with reduction of sources of own revenues i.e. various non-tax and quasi-fiscal burdens). Taking into consideration shown characteristics of own-source and other additional revenues, desired rationalization measures and improvement of budget process and practice, we estimate that the greatest potential impact of fiscal consolidation will amount to around 0.6 percent of GDP annually (in 2013). In following years impact will be reduced due to economically justified reduction of burden to businesses, which is the main source of own-source revenues. We estimate that the impacts will be reduced by 0.2 percent of GDP annually and the total potential impact of the fiscal consolidation in the period 2012-2016 would amount to around 1.5 percent of GDP.

## 12. TAX SYSTEM REFORM

**Current trends and problems**

Due to fiscally unsustainable decrease of tax rates in previous years, such as the decrease of wage bill tax in 2007, current capacity of tax system in the Republic of Serbia is insufficient to provide sustainable financing of public expenditures. Aside from inadequate capacity of the tax system, the structure of the system itself is problematic from the aspect of allocation efficiency and sustainable economic development in the following years – fiscal burden on labor is relatively high, tax burdening on consumption and property is relatively low, while there is a large number of quasi-tax forms which is undermining the predictability of the tax system and represents a significant barrier for doing business, especially in the case of small and medium-sized companies. Inadequate use of tax laws in practice has brought up a significant growth of informal economy and tax evasion in the previous period.

**Proposed measures**

1. Increase of net tax revenues for 1 percent of GDP and shift from taxing labor to consumption by increasing the general VAT rate to 22 percent; increasing the lower rate to 10 percent; transfer 1/5 of non-existential goods from lower to general VAT rate; increase excises for tobacco and alcohol; decrease employer contributions from 17.9 percent to 10 percent of gross salary and increase progressiveness of the income tax.
2. Suspension and/or limiting of quasi-taxation forms, where the loss of budget revenues would be replaced by the resources from regular tax forms – property tax on the local government level, and corporate income tax on the level of the Republic.
3. Improving the capacities of tax authorities and a decisive fight against underground economy and tax evasion.

**Expected effects**

The change in the tax system which would mean decreased tax burden on labor, and increased taxes on consumption and property, as well as suspension/limiting of forms of surcharges and taxes, which would have a stimulating effect on business environment; improve the allocation of resources and stimulate sustainable model of economic development. With the proposed measures, net budget revenues would increase by 1 percent of GDP, while 2 percent of GDP of the tax revenues would be transferred from taxing wages to taxing consumption, which would create the effect of fiscal devaluation, thus increasing competitiveness of domestic producers by decreasing unit labor costs for almost 7 percent. This way, the decrease of the very high foreign-trade deficit would be stimulated. Also, decreased tax wedge on wages, from RSD 61 to 45 on each 100 RSD of net salary, in the cases of the employees with minimal salaries, will contribute to a greater demand for labor and will encourage social support for a decisive fight against informal economy and tax evasion – which are becoming more and more an obstacle to the sustainable economic growth. Systematic fight against underground economy can bring 0.5 to 1 percent of GDP of additional revenues over the medium-term.

***It is necessary to increase total tax revenues by 1% of GDP in the short term, in order to provide for adequate volume of funds for financing the existing public***

***expenditure.*** It is not possible to implement fiscal consolidation exclusively by using savings measures on the part of public expenditure, in view of the current level of public debt, existence of significant structural deficit and the fact that restructuring of public expenditure system requires a period of several years[139]. In addition, due to the process of EU accession and economy rebalancing towards a viable model of economic growth, which implies a higher level of export and lower participation of import – keeping the current tax rates would mean reduction of tax revenues in Serbia in the upcoming years. Namely, reduction of trade deficit implies reduction of value added tax (VAT) revenue, which is calculated based on import but not on export, too, while reduced customs rates in the scope of the Stabilization and Association Agreement imply reduced customs revenues.

***The Fiscal Council believes that the necessary tax revenue increase of 1% of GDP in the short term is possible to be implemented only by increasing the consumption taxation.*** Possible increased corporate income tax could not result in increased revenues in the short term, due to the annual statement of liabilities in the case of this tax form. Also, opportunities for increasing revenue from this source are partially limited by accentuated regional tax competition and corporate income tax rates in the surrounding countries[140]. Possible increase of public revenues through property tax also requires a specific longer period of adjustment and cannot provide necessary results in short term. This approach, too, would require a change in local self-governments' financing system, because property tax revenues belong to local authorities, while the structural fiscal deficit is located at the central level of authorities. Finally, the Fiscal Council believes that possible public revenue increase by means of increase of tax levies on wages would have markedly negative effects concerning employment, and that it is an option that would be difficult to be medium-term viable.

***Necessary increase of public revenues of 1% of GDP – through additional taxation of consumption might be implemented by increasing the VAT rate and excise duties.*** VAT rate increase by 1 percent point, reduced rate from 8% to 9%, and standard rate from 18% to 19 % would provide almost 0.7% of GDP of additional revenues in the short term. The remaining necessary revenues amounting to 0.3% of GDP are possible to be achieved by increasing excise duties, primarily in the field of excises on tobacco and alcohol products. Additional revenues may also be realized by allocating specific non-existential categories of products from the reduced VAT rate to the standard VAT rate.

***The Fiscal Council recommends reassessment of economic justifiability of the present tax system structure in Serbia.*** The role of a tax system is to provide in a predictable, economically efficient and socially equitable manner an adequate amount of funds necessary for uninterrupted and viable financing of public expenditures. There is a consensus in the professional public that in the upcoming period it is necessary to change the model of economic growth of Serbia, so that main driving forces of the growth become export and investment instead of consumption (Bajec, Petrović, Stamenković et al. 2011; World Bank, 2012). In this context, the Fiscal Council proposes alternative approaches to the tax reform to be considered, which would stimulate transfer of economy to a viable model of economic

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[139] The only alternative to increased revenue by 1% of GDP in the short term could be a one-time reduction of wages and pensions by 5%. The above mentioned one-time reduction of wages and pensions, in this case, would be necessary to be carried out besides the planned reduction of public expenditure, which, *inter alia,* include wage and pension freeze for a period of one to two years.

[140] Given that corporate income tax amounts to 10% in Bulgaria and FRY Macedonia, or 16% in Romania, the Fiscal Council believes that anyincrease of corporate income tax rate over 15% in Serbia would certainly be counterproductive, while opportunities for partial increase of income tax rate below this amount could be analyzed. In addition, there is also space for significant increase of revenue from this tax form by means of abolishment of a large number of tax exemptions and tax credits.

growth. For instance, Arsić et al. (2010) suggest revenue-neutral reform, which would reallocate a significant volume of tax burden from wages to consumption by reducing social insurance contributions, increasing the progressivity of income tax, and increasing the value added tax burden[141]. Bearing in mind considerable growth of quasi-tax levies in the past few years, both at the local and Republic levels, it would also be reasonable to consider abolition and/or limitation of quasi-tax levies and their replacement with revenues from standard tax forms.

***The proposed orientation of the tax reform that would imply reallocation of the tax burden from wages to consumption, would create positive incentives in the Serbian economy:***

*a) Regional competitiveness and viable model of economic development*. The increased VAT rate would make domestic producers of goods more competitive in relation to foreign producers, both on domestic market and on foreign markets, because VAT is calculated on import of goods but not on exports of goods. Fiscal disburdening of wages would additionally improve competitiveness of domestic producers because it would lead to partial reduction of production costs in labour intensive branches[142]. Moreover, increased VAT rate would stimulate the change in aggregate demand in Serbia, which is long-term unviable, in the direction of reduction of consumption (VAT taxed) and increased export and investments (exempted from taxation in the VAT system).

*b) More efficient struggle against tax evasion and increased registered employment.* In the majority of East European transition countries, including Serbia, tax evasion is present in no small measure[143]. Tax evasion is mainly present in the segment of unregistered labour income, due to failure to register employees, or to register employees at the minimal or underrated tax base[144]. On the other hand, it is most difficult to perform tax evasion in the VAT system, where it would require organization of a chain of evasions along the entire production chain. Therefore, the proposed tax reform would imply (by definition) a momentary reduction of grey economy volume, which would enable the tax authorities to rely more on the most powerful tool in the struggle against tax evasion – the VAT system. Moreover, the proposed fiscal wage disburden, especially in the segment of the lowest wages, would help creation of a stimulating economic environment for registering the existing non-registered employees and job creation in the coming period[145].

***There are different approaches regarding reallocation of tax burden from wages to consumption.*** Given that social insurance contributions are the most significant fiscal burden on wages, three times higher than wage income tax, any more perceptible fiscal wage

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[141] Results of the OECD Study (2010) also suggest positive economic effects due to reallocation of tax burden from labour to consumption, because labour taxation has more negative impact on economic activity than consumption taxation.

[142] Reallocation of tax burden from wages to consumption creates the effect of the so-called *fiscal devaluation*, because export products of domestic producers become effectively cheaper. Advantage of fiscal devaluation as compared to nominal devaluation is that it does not cause increased costs of exporters based on foreign credit servicing or reproduction materials importation.

[143] Schneider et al. (2010) assess the grey economy value to be 36.5% of GDP in transition countries, as compared to 13.5% of GDP in developed OECD countries.

[144] Tax evasion due to registration of employees at the underrated tax base are especially difficult to be identified and successfully processed in practice, given that it is not easy to collect relevant probative materials – in particular under unemployment conditions exceeding 20%, wherefore it is hard to expect claimants' cooperativeness.

[145] Incommensurate fiscal wage burdening is only one of the causes of labour market problems. Other problems include rigid labour legislation and inadequate educational profile of labour force.

disburdening requires reduction of social contributions[146]. In this analysis we will orient ourselves towards the attitude implying wage fiscal disburdening by reducing contributions debited to employers, although in reality there are different alternatives[147]. Besides, there are various options regarding the increase of consumption tax burdening. The most important source of additional tax revenues from consumption is certainly VAT, however, it is also possible to realize limited additional revenues by increasing individual excises, primarily excises on tobacco products. In the case of increased value added tax, there are options to increase the VAT rate, to shift the turnover of non-existential goods from reduced VAT rate to general VAT rate, or to apply a combination of the two approaches.

**Table 12.1 The Amount of Annual VAT Subsidies by Average Household for Different Goods Taxed by Reduced Rate of 8%, 2009 (In RSD)**

| Decile distribution by household consumption | Bread and baking products | Milk and dairy produce | Meat and fish | Medicines | Utility services |
|---|---|---|---|---|---|
| 1 | 1,237 | 1,125 | 1,547 | 765 | 325 |
| 2 | 1,375 | 1,538 | 2,292 | 792 | 641 |
| 3 | 1,355 | 1,789 | 2,933 | 906 | 832 |
| 4 | 1,496 | 2,010 | 3,546 | 995 | 1,156 |
| 5 | 1,634 | 2,264 | 4,259 | 1,082 | 1,188 |
| 6 | 1,637 | 2,410 | 4,645 | 1,272 | 1,462 |
| 7 | 1,738 | 2,553 | 5,290 | 1,447 | 1,631 |
| 8 | 1,787 | 2,736 | 5,883 | 1,506 | 1,759 |
| 9 | 1,802 | 3,117 | 7,299 | 1,835 | 2,114 |
| 10 | 2,097 | 3,650 | 9,614 | 2,350 | 2,501 |

Remark: Calculations take into account the size of the household.
Source: Arsić and Altiparmakov, 2011.

***The rationale of taxation of basic existential products by reduced VAT rate is to protect the vulnerable social strata; however, it is well known in the professional literature that the VAT system is not an optimal tool for conducting social policy.*** Although the socially vulnerable population focus the major percentage of their consumption on basic (existential) goods, in absolute nominal amount the largest expenses for basic goods are made by citizens with above-average standard of living because their consumption is nominally the highest. Therefore, the highest amount of implicit VAT subsidies, which are a loss of tax revenues due to taxation by reduced VAT rate – are actually realized by households with above-average standard of living and the highest registered consumption (Table 12.1.). Good tax practice suggests that it is economically optimal to have a VAT system with uniform rate, whereby the standard of vulnerable social strata would be protected by adequate social policy measures and targeted public expenditure programmes (Abril et al. 2001).

***The list of goods taxable by reduced VAT rate in Serbia is too extensive as compared to the good tax practice.*** Currently, the list includes bread and baking products, milk and

[146] Reduction of contributions would not jeopardize the social insurance system of Serbia, which is functioning on the pay-as-you-go principle, wherefore it is possible to substitute to the lack of funds from contributions with funds from general tax revenues – which has been normally a daily practice over many years.
[147] For instance, it is possible to completely abolish health contributions and switch over to financing the health insurance system from general tax revenues. However, it is not possible to implement this approach in a short time, given the necessity to conduct a detailed review of health system functioning.

dairy produce, flour, sugar, eggs, oil, fruits, vegetables, meat, utility services, medicaments, fertilizers, firewood, natural gas, computer equipment, books, daily newspapers and hotel accommodation. Assessments show that some 40% of taxable VAT turnover is subject to reduced VAT rate. In the countries in the region, VAT systems in Montenegro and Macedonia also tax too many goods by reduced VAT rate. The list of goods taxed by reduced VAT rate in Croatia is considerably shorter, including the basic existential goods – bread (but not other baking products), milk (but not other dairy produce), medicaments, as well as books, newspapers and hotel accommodation. Bosnia and Herzegovina, Bulgaria and Slovakia decided for economically optimal VAT system design with (practically) uniform VAT rate. The Czech Republic, which until recently had almost identical structure of VAT system to Serbia, with a large number of goods taxable by reduced VAT rate, adopted in 2011 amendments to the law, stipulating abolishment of the reduced VAT rate and phase-introduction of uniform VAT rate by 2013. Hence, from the standpoint of optimal management of limited public resources, it is advisable to consider in the upcoming period to reduce the list of goods taxable by reduced VAT rate, and to implement more efficiently the aims of social policy regarding the budget expenditure.

*Is it possible to collect VAT upon realization?*

VAT systems were conceived in the manner that taxpayers pay their liabilities towards the government at the end of the accounting period (monthly or quarterly), depending on the invoiced turnover. VAT systems all over EU function based on the invoiced turnover, although EU regulations leave the opportunity to member countries to make possible, for special sectors or for special groups of taxpayers, to pay their VAT liabilities upon realized instead of invoiced turnover. However, experiences of several countries that allow individual groups of taxpayers to pay their liabilities upon realization, are markedly negative, wherefore these countries have been considering to abolish the option of VAT liabilities payment upon realized turnover.

In a part of Serbian public there is misapprehension that the current VAT system is inadequate because of requiring the payment of tax liabilities to the government “in advance” – which allegedly provokes major problems for business operations of small and medium-sized enterprises. Actually, in the present VAT system, based on the invoiced turnover, small and medium-sized enterprises pay their liabilities towards the government on average 55 days following the date of billing – because small and medium-sized enterprises mainly pay VAT quarterly, until the $10^{th}$ day of the following month, meaning that the average time of payment is 45 + 10 = 55 days after the billing (supposing that the enterprise’s operations are evenly distributed regarding time, the average billing time is the mid three-month interval, i.e. a 45-day period).

The payment period of 55 days after billing is adequate in the majority of European economies that do not suffer from the problem of chronic illiquidity. However, for many years in Serbia there has been a distinct problem regarding illiquidity of economy, whereby half a year may pass from the moment of billing till the moment of realization and collection. It is a matter of intrinsic and structural problem of Serbian economy, which is possible and necessary to be solved through adequate economic measures, such as more efficient conduct of bankruptcy proceedings. It is not possible to solve this problem by changing the VAT system, whose current structure is following the good tax practice and trends in the majority of European countries. From the standpoint of taxes, the only option available is possible increase of the threshold for entering the VAT system, from current RSD 4 million to RSD 6 million of annual turnover – insofar as this step would help an appreciable number of small and medium-sized enterprises.

***The general VAT rate of 18% in Serbia is among the lowest in the region.*** The general VAT rate in Hungary amounts to 27%, in Croatia 25%, on Romania 24%, in Bulgaria 20%, while in FRY Macedonia the general VAT rate amounts to 18%, just like in Serbia[148]. We may conclude that there is space for increasing the VAT rate in Serbia by a few percentage points, within the overall tax reform, which would imply switching over the tax burden from labour to consumption. In the scope of the said reform, it would also be advisable to consider more progressive wage taxation – by increasing the untaxable census and by increasing the tax rate applicable to the earnings exceeding the untaxable census[149]. More progressive wage taxation would make possible to provide for employees with the lowest wages the most significant fiscal disburden – there where the unemployment rate is most distinct and the most vulnerable employees are located. In Table 12.2 we may notice that the fiscal burden in the case of an employee who receives one half of his/her average monthly wage - which in Serbia approximately corresponds with the minimum wage - is currently in Serbia the highest in the region, after Romania[150]. In the continuation we present, as an illustration, a draft of the tax reform implying reallocation of tax burden from wages to consumption amounting to 2% of GDP, with the aforementioned provision of 1% of GDP of additional budget revenues in the short term.

**Table 12.2 Wage Fiscal Burden in the Countries in the Region, as the Net Wage Percentage, for Employees Receiving a Wage Equal to 50%, 100% and 200% of the National Average**

| Country | Fiscal burden for different wage levels | | |
|---|---|---|---|
| | 50% of average wage | 100% of average wage | 200% of average wage |
| Slovakia | 58% | 74% | 82% |
| Romania | 73% | 77% | 82% |
| Bulgaria | 52% | 52% | 52% |
| Czech Republic | 58% | 74% | 84% |
| Macedonia | 42% | 47% | 50% |
| Croatia | 49% | 62% | 85% |
| Serbia | 61% | 64% | 66% |
| Serbia – reform | 45% | 54% | 59% |

Source: Calculation of the Fiscal Council based on the official national data

148 Bosnia and Herzegovina has a unique VAT rate of 17%, which is a much bigger burden then our system as they do not have the reduced VAT rate. Montenegro has general VAT rate of 17% and the reduced rate of 7%, but the economy of Montenegro is not comparable to the Serbian economy.

149 More progressive taxation in the current system would provoke negative effects on local self-governments financing – because there would occur a regressive allocation of funds from underdeveloped municipalities to the most developed municipalities (Altiparmakov, 2011). Potential solutions of this problems lie in the change of the financing system of local self-governments, so that income tax revenues become a dominant revenue of the central level of authorities, or possibly by introducing a centralized allocation of income tax revenues. Contrariwise, it will not be possible to implement more progressive income taxation under existing conditions.

150 Data in Table 12.2 outline wage fiscal burden as the percentage of net wage, which has become a common practice in Serbia. International practice is to present the wage fiscal burden as the percentage of total expenses of an employer (*gross-2* wages). Actually, it is a matter of equivalent concepts; however, when making a comparative analysis of different countries it is necessary to pay attention whether relevant statistics are declared as the net wage percentage or as the percentage of total employer's expenses.

***Illustrative tax reform scenario:*** The increase of the reduced VAT rate by 2 percentage points, increase of the standard VAT rate by 4 percentage points, including reallocation of 1/5 of non-existential goods from the reduced rate to standard rate, partial increase of excise duties, primarily on tobacco products, and reduction of contribution rate debited to employers from the present 17.8% to 10% of gross wage. In addition, tax reform would imply a more progressive income tax structure, so that the highest fiscal disburden would be enabled in the segment of the most vulnerable employees with the lowest wages. To that end, in this example was simulated an option implying the increase of untaxable census to RSD 16,500 per month, including the increase of the nominal income tax rate from 12% to 15%. Besides the necessary increase of total public revenues of 1% of GDP, the proposed tax reform would enable significant reallocation of tax burden from wages to consumption, in the total amount of 2% of GDP. Moreover, the proposed orientation of the tax reform would result in the decreased inequality of the standard of living in the society – because the VAT increase would have proportional distributive effects, while fiscal disburden of wages would have progressive distributive effects. The proposed tax reform would increase competitiveness of domestic producers, because on average it would lead to reduction of unit labor costs for employers by 6.7%[151]. Table 12.3 outlines effects of the proposed tax reform on employees with different wage levels, while in Annex are given revenue effects of individual, illustrative, measures that may be implemented in the scope of the overall package of the tax reform.

**Table 12.3 Fiscal Income Levies (Income Tax + Employee Contributions + Employer Contributions), on RSD 100 of Net Wage of Employees, For Different Income Levels**

| Income level | Employees (%) | Current system | Tax reform |
|---|---|---|---|
| 50% of average wage (minimum wage) | 20 | 61.0 | 44.5 |
| 75% of average wage (median) | 30 | 63.3 | 50.5 |
| *Average wage* | *15* | *64.5* | *53.6* |
| 150% of average wage | 20 | 65.7 | 56.9 |
| 250% of average wage | 10 | 66.7 | 59.7 |
| 350% of average wage | 4 | 67.1 | 60.9 |
| 500% of average wage | 1 | 67.4 | 61.8 |

Source: Fiscal Council calculation

***In the medium term, for the purpose of establishment of a predictable tax system and enabling environment for economic activities, it is necessary to abolish and/or limit quasi-tax levies at the local and Republic levels, as well as the majority of tax credits related to corporate income tax.*** Quasi-tax levies create disproportional burden for relatively small economic entities, thus aggravating smooth functioning of market economy. Moreover, it is necessary to reconsider the practicability of existence of different tax credits, in the first place credits for investment into fixed assets, in the case of corporate income tax – given that the international practice implies lack of profitability of these forms of tax incentives in the case

[151] It was mentioned that reduction of unit labour expenses by means of fiscal devaluation, instead of nominal devaluation of Dinar exchange rate, does not cause any additional expenses for exporters due to foreign credit servicing or reproduction materials import.

of low nominal income tax rate, which is the case in Serbia[152]. Loss of income due to abolishment of a significant number of quasi-tax levies at the Republic level might be compensated by the aforementioned abolishment of exemptions and credits related to income tax, while the loss at the local level may be compensated by more significant taxation of property.

***In the medium term, it is necessary to improve the level of collection of property tax of physical persons at the local level, and to introduce the liability for legal entities to also calculate the property tax based on the appraised market value.*** Since the present property tax revenues in Serbia amount to only 0.7% of GDP, there is space for their considerable increase in the upcoming period. Preliminary results of 2011 Census imply existence of 3 million dwelling units in the Republic of Serbia, while according to the latest tax records there are barely 2 million dwelling units registered for property tax payment. Reallocation of property tax administration from the Republic level to the local level in 2007 has not given the expected results regarding better coverage of taxpayers[153]. In the upcoming period, it is necessary to achieve stronger recognition for property tax as one of the public revenue key sources at the local level – by introducing adequate financial penalty measures for municipalities with a large number of unregistered dwelling units. It is also necessary to harmonize tax treatment of physical persons and legal entities, because physical persons pay taxes in line with the appraisal of property market value, while property tax for legal entities is based on the book value, which is several times lower than the real market value.

***Introduction of new tax forms within the fiscal consolidation process that individual European countries made use of during the recent economic crisis, is an approach that may provide additional public revenues in the medium term, although of rather modest volume.*** A large number of European countries considered opportunities for introducing additional tax on unhealthy food and/or different approaches to (additional) taxation of the financial sector. The Fiscal Council believes that possible additional taxation of unhealthy food in Serbia would not be opportune - due to high administration costs for implementation and very limited opportunities for additional public revenues[154]. Regarding taxation of the financial sector, clear guidelines in the scope of EU have not been given a more definite shape so far. Financial transaction tax, which used to be applied in Serbia at some time past, is a very distortive tax form, especially in the case when its introduction was not coordinated in the scope of a larger number of countries and a broader economic union. Hence the good tax practice suggests that the possible taxation of the financial sector should be based on economic power of financial institutions (IMF, 2010). The most frequently considered approach to financial sector taxation is the financial activities tax, based on approximation of added value of the given financial institution (the aggregate of realized profit and costs for employees' wages), which is a kind of substitute for standard taxation of added value, given that financial institutions are exempted from the VAT system. Revenue potential of possible introduction of this tax form in Serbia would amount between 0.2% and 0.3% of GDP[155]. It is

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[152] Effective corporate income tax in 2010 amounted to 6.5% only, primarily due to tax credits for investment into fixed assets. By abolishing these credits, additional income of more than 0.5% of GDP at the annual level could be realized.

[153] Individual municipalities realized significant increase in property tax payers – unfortunately, it refers to a minimum number of isolated cases. Besides, the competent Republic bodies often refused to furnish local self-governments with relevant data necessary for expanding the property tax coverage.

[154] Instead of additional taxation on unhealthy food, it would be more efficient to consider allocation of individual non-existential goods from the reduced VAT rate to the general VAT rate.

[155] Possible implementation of this tax form would imply that the reduced VAT rate is applied for taxation of the tax base equal to the aggregate of profit and funds for costs of employees in financial institutions. From taxation

necessary for possible consideration of financial sector taxation to follow the current European practice and to be coordinated from the aspect of stability and solvency of the financial system of Serbia.

*Grey Economy, Tax Evasion And Capacity Building of Tax Authorities*

Grey economy and tax evasion are much more represented in transition countries than in the developed ones. Schneider et al. (2010) assess the volume of grey economy to be 36.5% of GDP in transition countries, as compared to 13.4% of GDP in developed OECD countries. However, it is important to highlight that the aforementioned assessments refer to the total turnover in the grey zone, while for assessment of additional budget revenues from the grey zone is relevant the size – *added value in the grey zone* which, depending on business activity structure, may be two, three or four times smaller than the assessed total turnover in the grey zone. Broader public often confuse assessment of turnover and added values in the grey zone, which contributes to unrealistic expectations regarding additional revenues that may be realized by the grey zone taxation in Serbia. Another cause of unrealistic expectations in this segment are implicit assumptions that the grey zone in Serbia may be almost completely eliminated through a resolute action by government bodies. However, grey economy and tax evasion are present even in the most developed countries in the world. Thus Schneider et al. (2010) and Schneider (2009) assess the turnover in the grey zone, in developed countries like Switzerland or United Kingdom, to amount to some 10% of GDP; grey economy of Spain, Greece or Italy to be some 25% of GDP; while grey economy in transition countries like Bulgaria, Romania, Macedonia or Serbia to be between 30% to 40% of GDP. Hence, taking into account administrative and social limitations present in the Republic of Serbia, it is not realistic to expect that a resolute action by government bodies could reduce, in the medium term, grey economy in Serbia to the level below 25% of GDP, which is the current assessment of grey economy in Italy, for instance. There certainly exists space for more efficient struggle against tax evasion; nevertheless, realistic assessments of possible additional revenues in the medium term range from 0.5% to 1% of GDP. However, implementation of plans for more efficient struggle against the grey economy will require undivided social support and more efficient acting of government bodies – through considerable improvement of work of Tax Administration and possible establishment of a specialized administrative court for the domain of tax evasion.

The study of the International Monetary Fund *Serbia: Implementing corporate strategies on organization, information technology, and compliance management in tax administration*, as of December 2011, identifies considerable space for improvement of activities and results of Tax Administration of the Republic of Serbia. Main areas of possible improvement are organizational structure of Tax Administration, more efficient use of information technology, as well as improvement of the number and qualifications of employees.

The mentioned study summarizes that organization structure of Tax Administration is obsolete, that it includes inadequate systems and procedures, limited material and human resources, information systems and applications. Special attention should be paid to the over-intricate and autonomous network of organizational units. Organizational units of Tax Administration all over Serbia (some 200) have too much autonomy and often believe

should be exempted insurance companies that are already paying (complementary) insurance premium tax of 5%.

instructions from the central office to be unbinding. It is necessary to strengthen the organizational structure and to put organizational units under obligation to implement decisions issued by the central office. Structure of employment in Tax Administration is not adequate. A small number of employees work in the central office of Tax Administration (5%, as compared to 10-15% according to the best world experiences), whereby more than one half working at the central office are in charge of managing and operational activities of the central office (according to experiences, one fourth is sufficient for these activities).

**Regardless of the chosen orientation of the tax reform, it is necessary to build administrative capacities of tax authorities, and initiate a resolute social action against grey economy and tax evasion.** A part of domestic public fails to clearly understand the damage provoked by grey economy and tax evasion – unregistered/illegal work is often considered to be less evil than impossibility to find any job at all. Although this is an unfounded belief, the tax reform that would substantially reduce labour fiscal burden, particularly in the segment of lowest wages, would additionally help breaking social delusions on justifiability of not paying "senselessly high" tax levies. Moreover, it is necessary to eliminate immanent inequities within the current tax system, such as privileged treatment of authors' fees, lawyers' income or property owned by legal entities – so that in the society could be created broad support to efforts put into building a credible, predictable and viable tax system, which is the backbone of all democratic societies and market economies. Within capacity building of administrative tax authorities it would be advisable to consider establishment of a specialized tax administrative court – given that both domestic and international practices suggest that the general court system often is not in the position to adequately process the narrowly specialized area, such as tax evasion. A resolute system struggle against tax evasion could in the medium term result in increased revenues from 0.5% to 1% of GDP (Randjelović, 2011)[156].

[156] The broad public often overvalue potential additional income due to suppression of grey economy and tax evasion. However, the seemingly modest increase of wages by 0.5% of GDP should not be misunderstood – possible absence of struggle against grey economy would mean the loss of the existing tax revenues and serious crumbling of the economic system of the Republic of Serbia.

**ANNEX – Revenue Effects of Different Reform Measures in The Field of Tax Policy**

| Tax measure | Revenue effect<br>% of GDP |
|---|---|
| Increase of VAT rate by 1% | 0.7 |
| Increase of VAT rate by 2% | 1.4 |
| Increase of VAT rate by 3% | 2.0 |
| Increase of VAT rate by 4% | 2.7 |
| Increase of VAT rate by 3%, with reallocation of 1/5 of non-existential goods from the reduced rate to the general rate | 2.5 |
| Increase of VAT rate by 4%, with reallocation of 1/5 of non-existential goods from the reduced rate to the general rate | 3.2 |
| Increase of the reduced VAT rate by 2%, increase of the standard VAT rate by 4%, with reallocation of 1/5 of non-existential goods from the reduced rate to the general rate | 2.7 |
| Reduction of the contribution rate debited to employer from 17.9% to 8% of gross wage | -2.5 |
| Reduction of the contribution rate debited to employer from 17.9% to 10% of gross wage | -2.0 |
| Increase of the untaxable census to RSD 16,500, with the increased wage tax rate to 15% | 0.0 |
| Increase of the untaxable census to RSD 25,000, with the increased wage tax rate to 20% | 0.0 |

Source: Fiscal Council

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