Fiscal Council

Republic of Serbia

PROGRAM of

FISCAL CONSOLIDATION IN 2012-2016

SUMMARY

May 30, 2012

FOREWORD

Serbia is heading towards a public debt crisis, which could occur by the end of this year. Preventing the crisis would demand immediate set of measures, first and foremost, in order to stop the crisis, and afterwards to help improve the status of public finances. The program of fiscal consolidation which is presented in this document proposes a set of measures which would help resolve immediate problems in 2012 and 2013 and which contains a reforms program which would enable consolidation of public finances in midterm period (2014-2016): a significant decrease of public debt and decrease of state deficit to a zero level. Since we are about to face big and painful cuts in public spending, this program foresees that the burden of fiscal consolidation should be evenly distributed and the most vulnerable groups of citizens would be protected. Finally, the proposed fiscal consolidation, along with the necessary structural reforms in Serbian economy, will represent basic stronghold for future sustainable economic growth.

Fiscal deficit and public debt have been strongly increasing through 2012 and by the end of this year they could easily reach the level of more than 6 and 55 percent of GDP, respectively. This trend certainly leads to a public debt crisis, which would manifest through a significant depreciation of dinar and the increase of inflation rate, on one hand, and decrease of output and the increase of the unemployment rate, on the other hand. This development of events should be prevented immediately – with tough measures. However, high deficit and increasing public debt are just partially the consequence of economic stagnation in Serbia and, consequently, lower tax revenues. Independently from the current crisis, i.e. in the case of normal economic growth, Serbia would still encounter fiscal deficit (so called structural deficit) of 4 to 5 percent of GDP. Such a high deficit, which would remain even in the period when the economy exits stagnation, is actually the main parameter of public finance problems in Serbia. On the other hand, this deficit also shows the necessity of tough „cuts" – from 4 to 5 percent of GDP – which would eliminate this structural deficit. This goal requires serious midterm reforms.

The size of both short-term (2012 and 2013) and medium-term (2014-2016) adjustment demands serious measures first and foremost on the side of expenses, but also a tax reform. Fiscal consolidation that we are proposing in this document envisages 4:1 ratio in favor of the decrease of expenses in comparison with the increase of revenues. This comes out of the fact that international experience shows that permanent recovery of public finance can be achieved first and foremost by the decrease of expenses, and also that public expenditures in Serbia are higher than in any comparable country.

Therefore, in this program we are proposing accentuated decrease of public expenditures (relative, in comparison to GDP), but also the change in the expenditures structure, which is important as well. Actually, we are proposing a significant growth of public investment into infrastructure. This is necessary in order to set the foundation for a mid-term economic growth in Serbia, but also to stimulate economic activity during this and following year.

Providing room for the necessary public investments growth means that there needs to be even more drastic decrease of current expenditures. There are no easy, painless solutions – only serious reforms and tough measures can provide that. The biggest part of public expenditures goes to salaries and pensions, so it is clear that these segments have to provide for greater adjustment. One additional, essential reason is that the value of salaries and pensions is unsustainable in relation to the abilities of the economy (GDP) to finance them, as well as the fact that it is much greater in comparison to any comparable countries. Recovery of public finance means that this expenditure has to be decreased to a level which could be sustainable to the economy. It will demand freezing of salaries and pensions during 2012 and 2013, as well as certain reforms of these sectors which will provide their further (relative, not absolute) decrease. Reforms imply the decrease of the number of employees in the public sector, as well as introduction of penalties for early retirement, raising the limit for retirement of women and other measures.

Reform of subsidies policy is the next important direction for expenditure decrease. At the moment, subsidies are abounding, and mostly non-selective, and therefore economically unjustified, so we propose that some of them should immediately be annulled, while others should be decreased and/or redefined. Behind all these high subsidies there is also a tough issue of restructuring an/or privatization of state-owned enterprises. First of all, this includes the reform of public enterprises – both local and state-owned, which, at least so far, has always hit the insurmountable wall of politics. But, there are also the enterprises in restructuring which „employ“ 97.000 people, while they are actually spending a generous amount of direct and indirect amount of subsidies. This is a huge burden on the shoulders of Serbian economy, so the new Government and the Ministry of Economy will have to face this problem. There should be a firm deadline – up to two years, in which these enterprises will either be privatized or go into liquidation.

In a broader spectrum of expenditures consolidation measures there is still a significant area of establishing a sustainable model for fiscal decentralization which was drastically violated by the amendments of the relevant Law in June 2011. Aside from the establishment of a rational, efficient and sustainable system, the solutions we are proposing should enable the necessary savings as well. Apart from these basic directions, decrease of public expenditures could be made by the decrease of expenditure for goods and services, by improving public procurements and decreasing corruption, thus suppressing informal economy, for which it would be necessary to reform Tax administration. Finally, we propose reform, i.e. abolishment of a number of state agencies, non-budget funds and similar institutions, which would, apart from the efficiency increase, make additional savings. Suppressing informal economy and improvement of public procurements would provide relatively high savings, especially mid-term – and they represent a significant component of fiscal consolidation – but are still far from the fact that their implementation could avoid increase of taxes and freezing of salaries and pensions. Savings made on agencies, funds and other, are important first of all, as a signal that any non-productive expenditures are being abolished, while their overall significance is relatively modest.

Tax reform which we are proposing has two basic targets: first, to change the structure of revenues by transferring taxation burden from labor to consumption, and second, to prevent the decrease of tax revenues as a share of GDP. Similar type of tax reform, as a response to the public finance crisis, was implemented by a great number of countries, such as Germany, Hungary, France and Croatia. An important motive was to use fiscal devaluation, i.e. decrease of unit labor costs in order to increase international economic competitiveness and thus stimulate exports. On the other hand, increase of consumption taxes leads to lowering of demand, and consequently to a decrease of imports. Both should help the necessary change of drivers of economic growth from expenditure and imports, towards exports and investments.

The other side of the coin of exports and investment-led economic growth is the decrease of tax revenues along with unmodified tax rates, i.e decrease of revenues from VAT, since its tax base (consumption and import) is decreasing. Therefore we suggest a tax reform which would produce additional revenues of 1 percent of GDP and prevent relative (in comparison to GDP) decrease of public revenues. Simply put, proposed tax reform provides that share of public revenues in GDP remains unchanged till 2016, at the level of approximately 40 percent. This means that tax burden (40 percent of GDP) would remain unmodified in spite of increase of tax rates, which would, of course, significantly change the burden allocation – from those who invest and export towards those who spend and import. Finally, in order to have the necessary effects on deficit and public debt decrease, tax reform should be delivered immediately.

Proposed fiscal consolidation program is one out of two basis of further economic growth of Serbia; the other basis are structural reforms which we haven't considered.[1]

In fact, since this fiscal consolidation prevent crisis, it also prevents decrease of output and employment. Surely, this comes with a price: in short-term (2012-2013) the proposed tough savings measures will modestly slow down the economic growth, which we still expect to be at least 2 percent in 2013 (if the European Union isn't hit by another crisis). In mid-term (2014-2016), however, consolidation will contribute economic growth through multiple channels. Firstly, one of them is the envisaged growth of public investments into key infrastructure projects. As soon as in 2012 and 2013, these investments should contribute to stimulation of economic activity and thus partly compensate the negative effect of proposed expenditure decrease and tax increase. After that (2014-2016), all of the built infrastructure should stimulate private investments and economic growth. The second important channel of impact of the fiscal consolidation to growth is lowering of interest rates and a greater inflow of foreign capital,

[1] One program for structural reforms was laid out in the World Bank document (2011): "Serbia Country Economic Memorandum – A path for progress: productivity and exports".

including foreign direct investments. Sustainable public finance – low public debt and small deficit – are crucial for macroeconomic stability, thus for capital inflow as well.

Fiscal consolidation program which is proposed in this document is similar to those programs implemented or announced by the states which have encountered similar challenges. It is a group of countries that are more developed than Serbia, such as Slovenia and Croatia, but also those that are similar to us – Romania and Latvia. Our program is closer to the programs of the first group, while Romania and Latvia were forced to implement a significantly tougher measures: significant cut of salaries and pensions and firing of employees in the public sector.

Pavle Petrović
President of the Fiscal Council

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 to grow in 2012 and 2013. The main driver of the public debt growth – fiscal deficit – will be significantly higher than the planned RSD 152 billion in 2012, since it has already gone to around 30 billion RSD more than planned in the first quarter. If nothing is done, by the end of the year, we expect that this gap would increase to around RSD 50 to 60 billion– which would then increase fiscal deficit in 2012 to more than RSD 200 billion, and public debt would be around 55 percent of GDP at the end of the year. Unfavorable environment for public finance in Serbia is also the fact that instead of the planned GDP growth of 1.5 percent, in 2012 there will probably be a stagnation, and in the case of a deeper EU crisis, there could even be a decrease of economic activity. Real depreciation of dinar, which happened in the first half of the year, additionally increases public debt share in GDP, since more than 80 percent of the debt is denominated in EUR and USD, and GDP is denominated in RSD. For this reason, it is necessary, right after the Government is formed, to start with tough measures for fiscal deficit decrease, to prepare a credible mid-term reforms plan which would permanently decrease public expenditures and to limit issuing of state guarantees, since their growth is also increasing public debt. In the study: „Proposal of measures for fiscal consolidation for 2012-2016“, the Fiscal Council identifies and analyses all of these topics and offers to the executive power a set of recommendations for deliverance of short-term measures for fiscal consolidation, as well as some structural reforms whose implementation would help return public finances in Serbia to a sustainable path and ensure a firm foundation for a high economic growth.

A threat of public debt crisis. Since end-2008 till the end of 2011, public debt of Serbia increased for about EUR 5.7 billion, while its share in GDP increased for almost 20 percentage points – from around 29 percent of GDP to about 49 percent of GDP. At the end of 2012, the share of public debt in GDP will additionally increase – considerably above the level of 50 percent of GDP, and in those cases, for countries which are similar to Serbia, it is likely to have a public debt crisis. Debt crisis occurs in the cases when investors evaluate that certain country will not be able to service its debt so they stop investing into the state bonds (See Chapter 2: „Public Debt of Serbia and its Sustainability“).

Serbia is currently highly dependent from new borrowing. By the end of 2012 alone, it is necessary to provide additional EUR 2.5 billion in order to finance deficit and pay the principal of previously obtained credits. If at some point there is a loss of investors' confidence in the solvency of the country, the state would not be able to find resources to finance some of its basic

obligations, and that would be a road to crisis. Investors' confidence depends on the fact whether the economic fundamentals show that there has been an improvement in public finance trends, but also, if that is not the case (Serbia), whether there are some Government decision and a credible plan of measures whose implementation would ensure state's solvency which would enable it to pay the debt.

Fiscal deficit is increasing – by the end of 2012 it will surpass RSD 200 billion if there are no appropriate measures. The main driver of public debt increase is fiscal deficit. In the first two years of crisis, fiscal deficit in Serbia was even a bit lower than in the EU. However, from 2010 or 2011, most EU member states rapidly decreased their deficit, mostly by increasing taxes, while deficit in Serbia remained almost at the same level from 2009 and was between 4.5 and 5 percent of GDP. In 2012, trends got worse. The data from the first quarter, when the plan was already surpassed for around RSD 30 billion, as well as some preliminary data for April, show a high increase of deficit of the general government. Our evaluation is that by the end of the year, instead of the planned RSD 152 billion, deficit could surpass RSD 200 billion (more than 6 percent of GDP) if firm measures for its decrease are not taken.

Deficit is increasing due to the decrease of public revenues, but also because of public expenditures. In December, the Fiscal Council was alerting to the possibility of deficit being higher than planned. Preliminary evaluation of the Fiscal Council from December stated that deficit in 2012 will be higher than the planned RSD 152 billion, since we expected that public revenues will be lower than planned. There are two reasons why we anticipated decrease of public revenues: a) public revenues were planned with an economic growth of 1.5 percent while our estimate from December (which is confirmed by data from this quarter) was that economic growth in 2012 will be 0 percent; and b) too optimistic projections for budget revenues, even in the case if a realistic GDP growth of 1.5 percent was achieved. Based on these two grounds, total deficit in 2012 would be RSD 30 billion higher than planned. In the meantime, however, there has been an additional increase of public expenditures, for which we expect, with the current trends, to be around 25 billion RSD on the annual level. Therefore we estimate that deficit – without firm measures for its decrease – in 2012 will be around RSD 55 billion higher than planned, and that all previously stated arguments prove that this increase is unsustainable.

New Government will, therefore, need to create tough measures immediately in order to decrease deficit in 2012 and 2013. The Fiscal Council evaluates that for a short-term sustainability of public finance and in order to avoid public debt crisis it is necessary to decrease fiscal deficit from present 6.2 GDP to 3 percent of GDP in 2013, i.e. to decrease it for around EUR 1 billion. Three basic measures which the Fiscal Council proposes to the new Government in order to have a short-term decrease of deficit are:

1) **Tax reform.** Proposal of the Fiscal Council is to have a tax reform in two phases. In the first one, which would come to power immediately after the Government constitution, we propose increase of both VAT rates – higher from 18 to 22 percent and lower from 8 to

10 percent. Also, we propose the transfer of 1/5 (non-existential) products from lower to higher tax rate and increase of excise tax, first and foremost for tobacco and alcoholic beverages. This way, there would be around 0.9 percent of GDP of additional tax revenues in 2012, and the deficit would be decreased for that amount (EUR 270 million). In the second phase, as of January 1, 2013, we propose decrease of fiscal burden on labor, by decreasing taxes and contributions burdening the employer from 17.9 percent to 10 percent of gross earnings, which would alleviate fiscal burden on labor from 64 percent to 54 percent for the employees with an average salary, i.e. to around 45 percent for the employees with minimal salary, restricting and limiting certain number of quasi-fiscal fees, abolishing exemptions and deductions within the corporate income tax and improving of legal framework related to property tax and its collection. Net effect of tax measures from 2012 and 2013 would be a permanent increase of tax revenues share in GDP for around 1 percent of GDP and reserving their unchanged share in GDP up till 2016 (See Chapter 12: „Tax system reform“). The standpoint of the Fiscal Council, and it is also economically justified, is to do the most part of the necessary fiscal adjustments by decrease of public expenditure, and not by increase of revenues. Therefore we propose that public revenues share in GDP should not be increased for more than 1 percent of GDP, short-term nor mid-term.

2) **Freezing of pensions and salaries in public sector.** Pensions and salaries would not be increased in October 2012 and would remain frozen throughout 2013. This would ensure, in 2013, to achieve the necessary decrease of share of the wage bill and pensions in GDP for around 1 percentage point and therefore it would decrease deficit for the same amount (EUR 300 million). Freezing of pensions and salaries, other than evident savings, would have an economic justification as well in the fact that the greatest difference in public expenditures structure in Serbia, in comparison to similar countries, is coming from high share of spending on pensions and salaries. In addition, public and state sector salaries in Serbia are significantly higher than in the private sector, and the ration between the average salary and pension in Serbia is among the highest in Europe.

3) **Establishing a sustainable system of fiscal decentralization.** Adoption of Amendments to the Law on Local Self-Government in June 2011, has created imbalance between revenues and liabilities of different levels of government, which has almost eroded public finance system in Serbia. The Fiscal Council proposes a complete withdrawal or a significant modification of the previously adopted amendments (modification example: adoption of a more just system of sharing the collected personal income tax, to be equally split between local and central government instead of the present 80:20 percent formula). Establishing a sustainable fiscal decentralization model, deficit would decrease for about 0.5 percent of to 0.7 percent of GDP, i.e. EUR 150 to 210 million (See Chapter 10: „Fiscal decentralization“).

The remaining part of short-term savings (from 0.3 to 0.5 percent of GDP or from EUR 90 to 150 million) would be provided through efficiency increase and rationalization within public administration. By that we mean improvement in functioning of state agencies and extra-budgetary funds, savings in public procurements and better system of tax collection. It should be kept in mind that, maybe opposite to the public beliefs, all these points actually provide very limited possibilities for saving, especially short-term. The biggest part of remaining necessary savings could be achieved through rationalization within different agencies, directorates and funds which are not under direct Treasury's control. We noticed, actually, that in 2012 there has been a significant increase of their expenditures – opposite to the flows in the state budget – which would have to be stopped immediately. For permanent establishing of an efficient system of functioning of state agencies and non-budget funds it will be necessary to have a broader reform which would demand abolishment of certain agencies/funds which are not necessary, merging those with similar functions, including them into the budget and other (See Chapter 11: „Independent revenues of budget users and non-budget funds"). [2]

During the short-term fiscal consolidation, social protection of the most vulnerable groups must be a priority. Increase of taxes and administratively controlled prices, along with the freezing of pensions and salaries of those employed in the public sector will have as a result a temporary decrease of citizens' standard. These stated measures are, however, necessary judging by all the facts, because even if they weren't done now, they will certainly be necessary after the crisis hits (naturally, at that point the measures would be even tougher and more painful). Therefore, it is the obligation of the government to protect the most vulnerable groups during the period of short-term fiscal consolidation. The Fiscal Council suggests that means-tested programs of social assistance to households and minimal pensions should be excluded from freezing. Aside from that, we also think it would be necessary to, both on the state and local levels, intensify social protection programs and deliver a determined and non-selective battle against corruption (See Chapter 4: „Fiscal Consolidation and Social Policy"). The program of fiscal consolidation is formulated so as to set the biggest part of the burden on those citizens whose earnings come from the public sector – since their earnings are higher than average at the moment, and the risk of losing their jobs is lower. We would like to stress once again that the decrease of citizens' standard is only temporary, and that with a consistent implementation of fiscal consolidation and proposed reforms it would be possible, at the middle of the observed period, to compensate for the negative impact of the implementation of these measures, and by 2016 positive impact would superseded them.

The Fiscal Council suggests a set of short-term measures which we feel are economically efficient and socially and politically acceptable, but there are also different alternatives

[2] Impact assessment in analyzed sectors indicates that it is possible to achieve the necessary saving in short-term (since the amount of evaluated reform effects, given in Chapters 6-12, is slightly higher than the necessary savings). However, it is not realistic to expect that all the reforms will provide for theoretically the best possible result in this and following year, so the achievement of wanted adjustment is uncertain.

depending on the Government's preference and macroeconomic developments. Out of many alternative short-term fiscal consolidation models, we have analyzed various different options for the tax reform. One of the possible scenarios was to increase higher VAT rate in two phases instead of one. In the first phase, it would be increased to 20 percent in 2012, and then, in the second phase, as of January 1, 2013, it would additionally be increased to 22 percent – along with the decrease of fiscal burdening on the labor. This scenario would have its advantages in the sense of more moderate transfer to new tax rates, but also some disadvantages, since fiscal deficit in 2012 would be decreased only to 5.5 percent of GDP, and there could be a missed chance to let the investors know that the priority of the new Government is fiscal consolidation. The second alternative would be to maintain the VAT rate increase to 20 percent, and, instead of additional two percent VAT rate increase, to proceed with a nominal decrease of pensions and salaries for 5-6 percent. Generally speaking, the alternatives: VAT rate increase/nominal decrease of pensions and salaries are practically equal from the point of view of fiscal consolidation. Depending on the preferences, the new Government could choose either one of the mentioned options. The third possibility, if the fiscal consolidation is not done through freezing of pensions and salaries, but only through tax rate increase, would mean that VAT rate would have to be increased to 26 percent or 27 percent. We consider this outcome as undesirable. It would be good to point out that there are certain risks that by the end of the year there will be a crisis escalation in the Eurozone and decrease of economic activity in Serbia – which would have a consequence of deterioration of fiscal trends. In that case, we suggest that along with all the stated short-term measures for fiscal consolidation, there should be a temporary postponing for the planned decrease of contributions.

In mid-term, deficit should be decreased from 3 percent of GDP in 2013 to a balanced budget in 2016 (deficit of 0 percent of GDP). Short-term fiscal consolidation will provide a stop in public debt growth, but in order to continue decreasing it and for a permanent sustainability of public finance in Serbia, it is necessary to continue with the deficit decrease in the period from 2014 till 2016. There is an economic need to provide the entire necessary mid-term deficit adjustment by decreasing public expenditure, and not by increase of tax rates. Also, within the boundaries of total decrease of public expenditure, it is necessary to change the unfavorable structure, i.e. to significantly increase the level of public investments. The current level of public investments, which is from 3.5 to (planned) 4 percent of GDP in 2012, is not enough to support economic growth. Therefore, along with total decrease of public expenditure of 3 percent of GDP from 2014 till 2016, it is by far necessary to decrease current public expenditure (salaries, pensions, procurement of goods and services, and subsidies), by 4 percent of GDP, in order to have another 1 percent of GDP (EUR 300 – 350 million) for the increase of investments.

Decrease of current public expenditure for 4 percent of GDP from 2014 till 2016 can be obtained through the legal indexation of pensions and salaries in the public sector and implementing mid-term structural reforms. As of April 2014, after the freezing in October 2012 and throughout 2013, indexation of pensions and salaries would continue in accordance with the

Budget system Law. This would enable the decrease of salaries and pensions share in GDP for about 2 percent till 2016, without their realistic decrease. The remaining 2 percent of GDP are supposed to be provided through implementation of structural reforms which, other than fiscal savings, should also significantly improve business environment, stimulate private sector development and thus support economic growth. It is essential to accentuate two points regarding structural reforms. Firstly, the first significant fiscal savings which will come out of the mid-term reforms can be expected in a year or two after the start of their implementation. Therefore, it is necessary to start with the reform implementation in 2013 at the latest, which means that they would have to be prepared during 2012. Secondly, implementation of this type of reform cannot be painless, therefore, in our analysis, we tried to avoid „commonplaces“ and we decided to give the most detailed proposals for measures which are necessary to be implemented in order to return public finance in Serbia to a sustainable path.

Pension reform and reform of salaries and employment system till 2016, would enable fiscal savings of around 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 their rationalization. The target of the pension reform would be, not only to make the system sustainable, but also to make if more just. Therefore, we suggest the introduction of the system of the factor of actuarial equity for early retirement, increase of age limit for women retirement and changes in age limit in accordance with the increase of life expectancy (See Chapter 6: „Fiscal sustainability of the pension system in Serbia“). Saving which would be made through these measures by 2016 are not high – they are around 0.2 percent of GDP (if the reform would come to power in 2013), but their true effect and permanent improvement of the pension system will be obvious in long-term (in 10-15 years), and not in mid-term. Reform of salaries and employment system in public sector that we are proposing would mean the introduction of a unified system of salary levels for those employed in public service, less employees in local administration, decrease of non-medical staff in health department and excess of teaching staff in elementary education (See Chapter 7: „Reform of Salaries and Employment in Public Sector“). With this reform, there could be savings of around 0.4 percent of GDP till 2016.

Reform of state-owned, socially-owned and public enterprises would enable mid-term budget savings on subsidies of around 0.6 percent of GDP but that will also decrease the amount of state guarantees for borrowing which, independently from fiscal deficit, increases public debt. A particular social problem during the implementation of these reforms could come out of the issue related to the resolution of status of around 640 companies in restructuring in the jurisdiction of the Privatization Agency, which still have around 97,000 employees (See Chapter 8: „Reforms of State and Socially-owned Enterprises“). These companies make annual losses of around EUR 400 million, and their arrears towards the government and public companies have reached the sum of around EUR 1.5 billion. Therefore, any further maintaining of this system, after more than ten years since the beginning of transition, is extremely costly and irrational. Among the proposed measures we point out: liberalization of activities in which public and state-owned companies are operating, and which don't have the character of natural monopoly; increase of prices for services provided by public state-owned and local companies up to the cost recovery levels; managing improvements of public companies, including their depolitization with the aim of improving their cost effectiveness and improve the quality of service. Improvement of operations of state and socially-owned and public enterprises will lead to decrease of public expenditure on subsidies (See Chapter 9: „Analysis of Possible Savings in Subsidies“). A special problem which we have noticed is that there has been a high increase of state guarantees for borrowing of public companies in the previous three years (See Chapter 3: „The Policy of Approving State Guarantees“). Reform of public and state-owned enterprises will decrease the need for issuing guaranties; in addition the Fiscal Council proposes to introduce a ceiling on guarantees. By that, we mean some form of legal limit on annual growth of guarantees, as well as legal limitations of purposes for which these guarantees are issued (high growth of guarantees in the previous three years is mostly the consequence of the fact that they have been issued for economically unjustified purposes – maintenance of current liquidity, refinancing of existing liabilities, procurement of goods and services, etc.).

Savings of around 0.6 percent of GDP can be made on the procurement of goods and services. The biggest part of procurement of goods and services is done outside of the central state budget – through the Republic Fund of Health Insurance, local governments, even agencies and extra-budgetary funds. Certain savings in procurement of goods and services can therefore be made directly – improving the system of public procurements, as well as indirectly – improving local governments' efficiency and business environment at the local level (See Chapter 19), and also improving the work of state agencies and extra-budgetary funds (See Chapter 11). Total mid-term savings which can be made on procurement of goods and services with the help of all these reforms by the year 2016 are estimated to around 0.6 percent of GDP.

The remaining 0.2 percent of mid-term savings can be obtained through the decrease of interest payments. Fiscal consolidation and structural reforms will contribute to the decrease of expenditure on interest through two channels. The first, and more significant for adjustment, is the decrease of share of public debt in GDP. Our projections show that through implementation of proposed short-term and mid-term measures, it would be possible to decrease the share of public debt for around 7 percent – from 55.8 to 48.6 percent of GDP (not including the debt related to restitution).[3] The decrease of public debt share in GDP directly decreases annual expenditure on interest. The second channel of decreasing expenditures for interest payments, is the decrease of interest rates at which the state would be borrowing, since the trend of public debt decrease influences the confidence of investors into the state's solvency and lowers the risk and the interest rate for its borrowing.

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

Fiscal consolidation and structural reforms will also set up the foundation for a high and sustainable economic growth. Strong decrease of fiscal deficit in 2012 and 2013 would provide macroeconomic stability and avoid possible depreciation of dinar and inflation explosion, which was the principle motivation of the Fiscal Council to prepare this study in the first place. However, it shouldn't be forgotten that decrease of fiscal deficit also has a positive influence on economic growth in mid- and short-term: 1) fiscal consolidation will provide a more favorable financing for the economy, due to a decrease in a country related risk premium and decreased volume of borrowing of the government on the domestic financial market; 2) structural change of public revenues and expenditures (increase of investments) will undoubtedly influence the rebalancing of Serbian economy from expenditure towards exports and the increase of competitiveness due to the effects of fiscal devaluation and 3) mid-term structural reforms will contribute to the growth by improving business environment, stimulating private sector development and increasing predictability of business environment. In the case of an unfavorable developments in the Euro zone and extended recession, these proposed measures would guarantee sustainability of the macroeconomic stability in Serbia.

The Fiscal Council represents the opinion that the fiscal consolidation measures are necessary and crucial, but not enough to create the environment of a long-term sustainability of the economic growth and increase of employment. Some of these reforms which are in connection to the fiscal consolidation, and are also important for the economic growth are: reform of the tax system, setting up a financial discipline, addressing the issue of informal economy, simplifying administrative procedures, fight against corruption, infrastructure development and modernization, improvement of public service quality (judicial, educational, administrative, etc.), reform of state-owned enterprises and other. Aside from that, all the sectoral reforms within the state (reform of education, health, defense, agriculture policy, culture, science, etc.) need to fit into the general balance framework which is determined by fiscal consolidation, which means the expenditure of around 40 percent of GDP. That has for a consequence that the GDP share of most of these sectors in the following four years will be decreased, and only in some cases remain unchanged – which means that the listed sectors could realistically count on higher amounts only based on GDP growth. However, it is clear that there are many other reforms which are not directly linked with fiscal consolidation, and that are necessary to be implemented in order to create a favorable environment for economic growth. Among these reforms are the reform of the labor market, improvement of competition policy, as well as numerous sectoral policies that are important for economic development (agriculture policy, development of non-banking financial sector, policies to stimulate innovation and others).

2. SERBIA'S PUBLIC DEBT AND ITS SUSTAINABILITY

Current trends and problems

Public debt in Serbia has been rapidly increasing during previous four years, so in 2011 it has exceeded the legal limit of 45 percent of GDP, and in 2012 it will be around 55 percent of GDP. Systemic causes for such trend of public debt haven't been resolved (fiscal deficit, guarantees) so, in the case of lack of fiscal consolidation, increase of public debt in relation to GDP will continue to grow. Serbia is already in the zone where the probability of a debt crisis is not small. Every additional increase in public debt as a share of GDP increases the above mentioned probability – possible lack of agreement with IMF could be the trigger which would start the debt crisis in Serbia.

Proposed measures

1. In short-term: preservation of the existing legal framework which sets that the maximum level of the public debt as a share of GDP should be limited to 45 percent (not including the debt related to the restitution), and structural fiscal deficit to 1 percent of GDP. In addition, it is necessary to have a precise definition of the public debt, as well as the way for calculating its share in GDP.
2. In mid-term, legal framework would be improved by:
    - aligning the rules for structural fiscal deficit with that of the EU;
    - adopting the rule on sequential limits for public debt, whose reaching would automatically oblige the government to take predefined measures in order to stop the increase of public debt.
3. Key measures in order to stop the increase of public debt are:
    - rapid reduction of the fiscal deficit in 2013 to around 3 percent of GDP and adopting a balanced budget by 2016;
    - limiting the amount of guarantees to 2 percent GDP during the following four years, i.e. to 0.6 percent of GDP during one year.

Expected effects

Fiscal consolidation would significantly slow down the growth of public debt as a share of GDP in 2013, and that growth would be stopped in 2014, which would mean that the share of public debt in GDP (not taking into concern temporary increase of liabilities in connection to restitution in 2015) would start decreasing. Over the medium-term, after 2016, Serbia's public debt would stabilize at the level of 35-40 percent of GDP. Fiscal consolidation which would decrease structural fiscal deficit, and therefore remove the systemic reasons behind the growth of public debt in relation to GDP, would significantly decrease the risk of debt crisis in Serbia, which would contribute to the improvement of environment necessary for economic growth.

3. THE POLICY OF ISSUING STATE GUARANTEES

Current trends and problems

According to the Public Debt Law and the Budget System Law, guarantees are part of the public debt in Serbia. The increase of these guarantees has contributed for the public debt to surpass the legal limit of 45 percent of GDP at the end of 2011. Guarantees have particularly accelerated their growth in the past three years. In the period from 2006-2008, the annual increase of guarantees was around 0.3 percent of GDP, while in 2009-2011 it was around 1.4 percent of GDP. Also, in the past three years there has been a significant change in the purpose of issuing a guarantee. Till 2009, guarantees were mostly issued for infrastructural projects, while lately they have been issued for investment project of private and public companies (FIAT, JAT, mining company Bor and others), but also for economically unjustified purposes – maintaining current solvency, refinancing of existing liabilities, procurement of goods and services etc.

Proposed measures

1. Limiting the maximum of the allowed sum for guaranteed debt in the following four-year period to 6 percent of GDP (excluding Public Enterprise „Road of Serbia“), following its decrease after 2016. In this respect, there is a proposed legal limit for growth of guarantees to 2 percent of GDP in the four-year period (2013-2016) and 0.6 percent of GDP on the annual level.
2. Legal definition of purposes for which state guarantees can be issued in order to limit them to significant infrastructural projects.
3. Unified mid-term managing of guarantees as a part of public debt, i.e. unified central monitoring, planning and controlling of flow of indirect liabilities of the state in mid-term period (three to four years).
4. Coordination of public (budget) investments, investments from guaranteed credits and involvement of the public sector into the construction of infrastructure; public-private partnership.

Expected effects

Decrease of public debt in 2016 for 2-3 percent of GDP in relation to the level of public debt which would be obtained with the present trend of the growth of guarantees.

Proposal of sustainable model of issuing state guarantees will influence the decrease of public debt growth in the following four-year period. If issuing of state guarantees would continue at the same pace as in the previous three years till 2016, their share in GDP (without PE „Roads of Serbia“) would be between 8 and 9 percent of GDP. With the proposed measures, that share would be limited to 6 percent of GDP.

4. FISCAL CONSOLIDATION AND SOCIAL POLICY

Current trends and problems

Since the economic crisis began, the standard of citizens has been seriously deteriorated: unemployment rate has reached close to 25 percent, the poverty rate is higher than 10 percent, and there is a relatively high number of citizens slightly above the poverty line. Increase of taxes and administratively controlled prices will result in a temporary additional deterioration of the living standards. Inefficient state sector and the presence of corruption decrease readiness of the citizens to accept the burden of fiscal consolidation.

Proposed measures

1. Means-tested forms of social safety net and minimal pensions would be excluded from freezing, which would protect the poorest citizens from tax increase and the increase of administratively controlled prices.
2. On the state level, there would be a fund for one-time assistance to the most vulnerable groups of citizens.
3. Local communities would be included into providing social assistance more intensively.
4. Decisive and non-selective fight against corruption.
5. Balanced distribution of fiscal consolidation burden.

Expected effects

The program of fiscal consolidation would temporarily deteriorate standards of living in an organized way, which is a necessary condition in order to prevent debt crisis and an even greater decrease in living standards. Burden of consolidation above average would have to be taken by those employed in the public sector, which is justified from the economic point of view, since the salaries in public sector are higher than in the private sector, and the risk of losing their jobs is lower. The living standards of the poorest citizens would be protected by increasing their income in accordance with the price growth. Prevention of corruption, improvement of the quality of services provided by the state and creating conditions for the economy to return to a long-term sustainable growth would also increase the readiness of citizens to accept these temporary savings 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.

6. FISCAL SUSTAINABILITY OF THE PENSION SYSTEM IN SERBIA

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.

7. REFORM OF THE SYSTEM OF SALARIES AND EMPLOYMENT IN PUBLIC SECTOR

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.

8. REFORMS OF STATE AND SOCIALLY-OWNED ENTERPRISES

Current trends and problems

After ten years of transition, Serbia still has around 1,300 companies under state control (state and socially-owned enterprises). High share of these companies in GDP, assets and employment has a negative effect on economic efficiency, financial discipline, corruption and other. In 2010, total losses of state, socially-owned and public enterprises were around EUR 1 billion (around 3.5 percent of GDP). Those companies in jurisdiction of the Privatization Agency engage serious resources (their employ around 5 percent of the employees in Serbia and engage around EUR 5 billion of assets), while their results are extremely poor (they contribute by 1.5 percent of GDP, their annual losses are around EUR 400 million, and their outstanding liabilities towards the state and public enterprises are around EUR 1.5 billion). From the fiscal point of view, it is relevant if these enterprises receive direct support since this increases total expenditures and a budget deficit. In addition, state-controlled companies get significant indirect subsidies such as state guarantees for credits, tolerance of unpaid taxes, covering for unpaid contributions to the pension fund, which have a consequence of increasing of current and future public expenditures and decreasing of public revenues. Total expenditure of the state for the support it provides to these companies (direct subsidies, transfers for unpaid contributions and expenses for servicing of the guaranteed debt) in 2010 was around 2.7, and in 2011 around 2,3 percent of GDP.

Proposed measures

1. Assigning a limited period of about two years during which the status of the companies in jurisdiction of the Agency would be resolved, including the companies in restructuring, either through privatization or liquidation.
2. Setting up a firm budget constrain with the efficient application of liquidation procedure, shortening deadlines and other, as well as a gradual elimination of subsidies for companies in the process of privatization.
3. Resources for the social programs for those employees who would lose their jobs in the privatization process or liquidation should be provided. Significant share of these resources could be provided through savings on subsidies.
4. In the case of larger companies in restructuring, measures aimed at improving their management should be taken, in order to increase the chances for their privatization.
5. Improvement of corporate governance and depolitization of public and other companies that are state-owned.
6. Privatization of state-owned companies which operate or are able to operate in competitive conditions (Telekom Srbija, Galenika, Železara Smederevo, companies owned by Srbijagas and other) and privatization of some parts of the Electric Power Industry of Serbia.
7. Increasing the price of public companies' products and services to their cost-recovery levels (electricity, gas, heating, and other).
8. Effective liberalization of sectors which are dominated by public enterprises, and which don't have the character of natural monopoly (energy production, railway transport, some utility businesses).

Expected effects

Expected fiscal effects: decrease of direct and indirect subsidies to the companies including decrease of issued and active guarantees, improvement of tax collection, making revenues from privatization which would directly or indirectly decrease public debt. Direct budget and non-budget savings on subsidies for state-controlled companies in 2013 could be around 0.3 percent of GDP, while mid-term (2014-2016) they could amount from 0.7 to 0.9 percent of GDP.
Expected economic effects: increase of the efficiency in the entire economy, better quality of services of public companies, economic activity and employment growth, setting up financial discipline and decreasing corruption.

9. ANALYSIS OF POSSIBLE SAVINGS IN THE AREA OF SUBSIDIES

Current trends and problems

Expenditure on subsidies in Serbia, when we consider not only budget payments but also all the data on all direct and indirect subsidies given by all state levels, can be evaluated to 4.6-4.8 percent of GDP, which is around 3 percent of GDP higher in comparison to the average in the EU member states. On the other hand, it can be noted that the efficiency of subsidies program in Serbia is much lower in comparison to comparable EU member states (for example, lower value of export of agricultural products per hectar of arable area, poorer quality of services in railway transport and other). According to that, it is necessary to do a thorough reform of the subsidies system in Serbia, which would have the aim to decrease total expenditures for these purposes and improvement of the subsidies program efficiency.

Proposed measures

1. Gradual decrease of subsidies for investments and employment (for example, for 0.05 percent of GDP each year) and limiting them only to large investments. Other than that, they should be done more in a form of implicit subsidies (through land concession and other), and less through direct budget payments.
2. Termination of direct and indirect subsidies for companies in jurisdiction of the Privatization Agency in the period of 2 years.
3. Changes in structure and mechanism of giving subsidies to the railway, in the sense of termination of subsidies for current costs (salaries for employees) and increase of subsidies for investments, where these subsidies would only be directed towards investments in priority projects.
4. Changes in structure and mechanism of subsidies in agriculture through decrease and changes made in the way the production is subsidized and increase in investment for agricultural infrastructure, so that these subsidies help to increase productivity and contribute to the elimination of bottlenecks in agricultural production.
5. Decrease of subsidies to local utility companies, along with the improvement of cost efficiency and increase of prices of some utility services. Providing further subsidies should be conditioned with the implementation of program for operational improvements of these companies. Privatization of those local public companies that don't have the character of natural monopoly would also contribute to these savings and efficiency improvement.
6. Suspension of tax exemptions for corporate income tax, as well as the decrease of other programs of indirect subsidies, and providing alternative possibilities for additional decrease of some of the existing subsidies programs, in the case of need for an *ad hoc* intervention from the state (for example, in the financial sector) because of the effects of an economic crisis.
7. Improvement of registers of all types of direct and indirect state aid, which is currently incomplete especially in the case of non-budget institutions and local budgets, as well as the indirect subsidies on all state levels.

Expected effects

Potential savings on expenditure for subsidies, which would be generated this way, are estimated at 1.6-1.8 percent of GDP, out of which the savings of 1 percent of GDP could be made in short-term (as early as 2013), and additional savings of 0.6 to 0.8 percent of GDP over the medium-term (in the next two to three years). This type of reform of the subsidies system would significantly contribute to the process of fiscal consolidation, but would also improve efficiency and effectiveness of the subsidies programs in Serbia.

10. FISCAL DECENTRALIZATION

Current trends and problems

Main problems in the area of fiscal decentralization and local public finance are: imbalance in distribution of revenues and expenditures between the Republic and local governments, low efficiency levels in delivery of services and limited responsibilities of local level of government. Vertical imbalance is evidenced through surplus revenues in comparison to responsibilities on the local level and lack of revenues in comparison to responsibilities on the level of the Republic in the amount of 0.6-0.7 percent of GDP. Vertical imbalance represents an urgent problem, which is connected with the increase of fiscal deficit and growth of public debt, so therefore it needs to be addresses in a short term. Middle level of state administration in Serbia is characterized by an obvious asymmetry – on one part of its territory there are autonomous regions which have a high and overall autonomy, while in the region of central Serbia there are statistical regions whose jurisdictions are minimal.

Proposed measures

Short-term measures

1. During 2012, on the level of the central government measures which would prevent growth of salaries and employment on the local level should be adopted, while local governments would be encouraged to decrease their arrears, increase investments and improve the position of local budgets.
2. Since the beginning of 2013, there would be measures which would aim to create sustainable fiscal decentralizations, which would mean to: increase the share of the Republic in the income tax to around 60 percent. Alternatively, some additional functions would be transferred from the level of the Republic to the local level.

Mid-term measures

1. Measures which would directly influence improvement of local budgets: decreasing the number of employees on the local level, decreased subsidies to utility companies, improvement of cost effective investments, transfer of property to local governments.
2. Measures which would indirectly influence efficiency improvement of local governments: strengthening the competition among local governments, improvement of transfer policy and political decentralization.
3. Measures which would improve economic environment on the local level: decreasing administrative barriers and corruption on the local level and improvement of local taxes.

4. Gradual increase of jurisdiction of local governments in areas of education, health and social protection by gradual transfer of jurisdiction and revenues from the Republic to local governments.

5. Gradual and selective increase of jurisdictions of regions in the function of increase of efficiency in public sector.

Expected effects

Short-term measures would provide decrease of arrears of local governments, increase of investments and improvement of local budgets. Increase of share of the Republic in allocation of income tax revenues would influence the decrease of consolidated fiscal deficit for about 0.6-0.7 percent of GDP. Apart from that, income tax would therefore once again become predominantly the tax of the Republic, which enables its further reform.

Mid-term and long-term measures would bring the savings of around 1 percent of GDP, with the existing level and quality of services. Improvement of economic environment would increase the investments and employment, and therefore the revenues of all the levels of state. With the same share from GDP, the quality of public services could be improved if, after detailed preparation, some functions in the areas of education, health and social protection would be transferred to local level. Passing some jurisdictions onto regions could contribute to the increase of efficiency of the entire state.

11. OWN REVENUES OF BUDGET USERS AND EXTRA-BUDGETARY FUNDS

Current trends and problems

In Serbia, there are around 160 state institutions and bodies which have their own revenues, by selling goods, providing services and charging fees for issuing certain licenses, permits, opinions etc. According to the estimate of the Fiscal Council, own revenues in 2012 will amount to around RSD 100 billion. It is a common practice that those revenues are left to the budget users to spend them based on their own discretion, therefore these own revenues of budget users are only exceptionally part of the general budget revenues. Total expenditures financed from own and other additional revenues were almost doubled in the past four years, and according to the expenditures' structure, most of it is spent on goods and services, then on subsidies, salaries of the employees and capital investments.

Proposed measures

1. It is necessary to make a comprehensive register of all budget users, as well as the extra-budgetary users that are mostly financed from fiscal and quasi-fiscal revenues. This would enable better control of their revenues and expenditures and centralized liquidity management. Own revenues of budget users should be shown more transparently in the budget.
2. It is necessary to include revenues and expenditures of all extra-budgetary users into a consolidated balance of the state.
3. In the first phase, a significant part of fiscal and quasi-fiscal revenues of budget users and extra-budgetary funds should be included into the budget as a general budget revenue, and then reduce the expenditures of those budget users.
4. In the second phase, savings are achieved through consolidation of institutions, i.e. termination of unnecessary budget users and extra-budgetary funds or by merging them into their line Ministries.

Expected effects

There could be possible savings in public procurements (goods, contracted services, specialized services – total of around 0.25 percent of GDP), moderate savings (around 0.03 percent of GDP) on expenditure for subsidies financed from own revenues, and the effect based on more rational expenditure on salaries we evaluate to around 0.15 percent of GDP. Transfer of resources of extra-budgetary funds would bring additional 0.2 percent of GDP. We evaluate total fiscal effects of the reform in the area of own revenues to around 0.8 percent of GDP in 2012 and 2013, and around 1.5 percent of GDP for the entire period (2012-2016).

12. REFORM OF THE TAX SYSTEM

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.