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Fiscal Council
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SUMMARY ASSESSMENT OF THE FISCAL COUNCIL

OF THE 2012 SUPPLEMENTARY BUDGET AND THE FISCAL SUSTAINABILITY OF THE REPUBLIC OF SERBIA

The current alarming state of public finance in Serbia demands decisive fiscal policy measures. The first eight months of 2012 were marked by almost uncontrolled growth of the fiscal deficit, and consequently of public debt—such that a debt crisis has become very likely. By year-end the fiscal deficit will reach 6.5% of GDP and public debt will be about 60% of GDP. This depressing situation is aggravated by the fact that in the brief time available through December, Serbia will need to obtain in the financial market or through bilateral agreements about €1.7 billion, and another €4–5 billion in obligations will become due in 2013. If a crisis is to be averted, decisive short-term fiscal consolidation measures must be implemented immediately in order to put out the fire, but it is also necessary to initiate without delay structural reforms to ensure that Serbia's public finances are permanently sustainable.

After the analysis of most recent developments with in public revenue and public expenditure, the Fiscal Council estimates that unless the Government moves fast, the consolidated government deficit could reach about RSD 216 billion (6.5% of GDP) by the end of the year. This estimate is higher than the Council's estimate of about RSD 206 billion in its May 2012 report. The fiscal framework Serbian government agreed with the IMF in December 2011 set a 2012 deficit target of RSD 152 billion, which means Serbia may over-shoot the planned deficit by as much as RSD 65 billion. At the level of the republic, which accounts for the bulk of state public activity, the Council estimates that unless the Government moves promptly, the 2012 deficit will amount to RSD 197 billion.

By year-end Serbia's public debt will amount to about 60% of GDP. At the end of July 2012, according to data from the Ministry of Finance, public debt had already reached €15.5

billion, about 55% of GDP. According to the Budget System Law, unguaranteed borrowing by local governments now amounts to about 1.4% of GDP, bringing Serbia's total public debt to about 56.5%. But it will not stop there. By year-end public debt will have grown to, and may even exceed, 60% of GDP, because the government will have to borrow about 3.5% of GDP, primarily to finance the deficit and to increase deposits that are below required levels. Public debt could also rise due to disbursement of guaranteed loans that were previously approved but not disbursed. Thus the Council estimates that—assuming there is no major change in the value of the dinar—public debt by the end of 2012 will be about 60% of GDP.

The challenge is serious: By year-end, about €1.7 billion will be needed to finance the deficit and repay debt, and another €4–5 billion in debt will come due in 2013. Besides financing the deficit and increasing deposits, principal repayment of about €880 million will also become due by the end of 2012. To finance government obligations through December Serbia must find about €1.7 billion in the financial markets or through bilateral agreements. This will be very difficult. Note, too, that before January Treasury bonds worth €530 million will become due, and rolling over even that borrowing could be a tough proposition. The Government should right now be preparing an urgent plan for financing deficits and repaying debt principal coming due in 2013. It is particularly important for Serbia to also know by the end of this, 2012 year where it expects to find the funds—about €700 million—it will need to finance government obligations in January and February.

There are clear indications that the government agrees in principle with the Fiscal Council diagnosis of the current state of public finance. Recent statements by officials indicate that in the administration and competent ministries there is clear awareness of the magnitude of Serbia's current financial problems. The statements are in line with the Fiscal Council's analyses and assessments (see the Fiscal Council's report from May 2012: "Proposed Fiscal Consolidation Measures 2012-2016"). In response to the deterioration, the Government has announced a fiscal consolidation program to reduce the deficit and put the brakes on the growth of public debt.

Unfortunately, the government's first response to this alarming situation, the supplementary budget, is ineffective although the structural measures related to tax policy and reduction of pension and wage growth are essentially good. Instead of reducing the deficit, the proposed supplementary budget for 2012, instead, increases it because of a large increase in expenditure ("the thirteenth pension." subsidies, etc.) that exceeds the savings that will be generated in 2012 by reducing pension and wage growth and increasing taxes (VAT, excise duties, etc.). More generally, the full effects of the measures related to tax policy and restriction of wage and pension growth, though structurally necessary, will not be felt before 2013. It is also true that the increase in some expenditure in the supplementary budget is one-off and temporary, lasting only until the end of the year. Nevertheless, if the entire package is to be credible, the first step in fiscal consolidation through the supplementary republican budget has to be a deficit decrease, even taking into account that the deficit increase is most likely to be temporary.

If it were not for the supplementary budget, the 2012 republican budget deficit would amount to about RSD 197 billion, and the consolidated government deficit would amount to about RSD 216 billion (6.5% of GDP). Those deficits are considerably higher than was planned and agreed with the IMF at the beginning of the year (RSD 152 billion for government as a whole and RSD 140 billion for the republican budget). The deficit has risen because the macroeconomic environment has deteriorated (lower GDP growth, higher inflation, and lower dinar value relative to the plan), and because in the first half of the year fiscal policy was strongly expansionary. According to the Fiscal Council assessment, relative to the past IMF agreement on the deficit target, deterioration of the macroeconomic environment contributed 45% to the deficit increase and expansionary fiscal policy about 55%.

The supplementary budget provides for savings and revenue to increase by over RSD 20 billion. Amendments to tax laws (increases in the general VAT rate [from 18% to 20%], excise duties on tobacco products, and the personal income tax rate) will reduce the deficit by RSD 15–17 billion, and lower October wage and pension indexation will save about RSD 4 billion. Another RSD 1–2 billion will be saved on the spending of budget beneficiaries, whose own-source revenue will be transferred to the general revenue of the Republic. The Fiscal Council considers all these measures to be in line with good public finance management practices and, therefore, positive.

The supplementary budget, however, raised spending by over RSD 25 billion. Payment of the "thirteenth pension" is a new and fiscally very generous expenditure measure that increases the deficit permanently. It gives all pensioners with monthly income below RSD

15,000 an additional annual transfer from the republican budget of RSD 16,000. In 2012 this will cost the government about RSD 4 billion. The Fiscal Council believes that this measure is is not only fiscally irresponsible, it is also poorly targeted and inconsistent with the pension and social care system. The supplementary budget also increased subsidies and budget loans to the real sector (Fiat, construction, railcar manufacture, subsidized liquidity loans, etc.) by over RSD 10 billion.

The current system of subsidies in Serbia is wasteful and unselective, so any subsidy increases (even if some of them are justified) should have been preceded by savings and by re-examining the justification for current subsidy allocations. Besides the increases in the real sector, agricultural subsidies were increased by about RSD 9.5 billion, presumably to mitigate the consequences of drought. The Fiscal Council believes that this measure can be justified only if the funds are targeted toward those most affected by the drought and if it is a one-off aid rather than a permanent increase in agricultural subsidies. A permanent increase would be fiscally responsible only if offset by a reduction in other government subsidies.

Certain ministries plan higher wage growth beyond the statutory indexation. The supplementary budget raises the wage bill relative to 2011 year by almost 15%, which certainly cannot be explained by statutory indexation. A detailed analysis by ministry showed increases in personnel expenditure that violate all legal restrictions on public wage movement (e.g., the Ministry of the Interior). The practice the Council has observed at the local as well as the republican level of finding ways to increase wages irrespective of indexation reduces the credibility of one of the most important fiscal consolidation measures. It thus poses a major threat to fiscal sustainability.

Funds for new measures and policies could have been provided by prioritizing and redistributing available funds at all government levels, rather than increasing the deficit. Note that in 2012 certain budget beneficiaries and government levels, primarily local self-governments, increased their spending by unusually large amounts. In the first half of 2012 local spending on subsidies rose in real terms by as much as 40%, on procurement of goods and services by about 30%, and on wages by about 12% relative to the same period in 2011. The Council is therefore of the opinion that it is necessary to establish without delay a mechanism that will, after reviewing the justification and streamlining of local self-government expenditure, generate significant savings before the end of this year. Those funds could be used to finance certain new government measures (e.g., mitigating the consequences of drought) that are currently to be financed by increasing the deficit. Serious fiscal consolidation is not possible, or is at least very difficult to implement, without eliminating the imbalances between the budget revenue and expenditure of the Republic and local communities that were created by the 2011 amendments to the Law on Local Self-Government Financing.

If Serbia is to avert a debt crisis in the next few years, deficit reduction (fiscal consolidation) must be dramatic. Growth in public debt appears to be inevitable in 2013 as well as this year because it is to a great extent predetermined by the current high deficit and the weak economic recovery. The growth trend of the share of public debt in GDP can, however, be reversed in 2014, at which time Serbia can begin to reduce it permanently; the Fiscal Council has devised an appropriate fiscal deficit path: in 2013 the fiscal deficit should be 3.5% of GDP, in 2014 1.9%, and in 2015 1%, so that in 2016 fiscal balance would be achieved. If there is a deficit adjustment that is strong but not as strong as the Council recommends (something that is suggested by a preliminary announcement of the Government that the deficit in 2014 will be 4% of GDP), the public debt-to-GDP ratio would continue to grow in 2014 as well, at which point there is a very high probability that Serbia will become bankrupt.

Of the three groups of measures that can help avoid a public debt crisis, the Government has launched two. In its May report, the Fiscal Council defined the three pillars on which a successful fiscal consolidation program must rest: (1) tax reform; (2) freezing of wage and pension growth (the largest public expenditure items); and (3) savings generated by reforms to improve efficiency in the public sector. The Government has so far embarked upon the first two. Although there are certain modifications from the Council's proposal, the fiscal implications of measures proposed by the Government in the area of tax policy and wage and pension growth control are practically identical to what the Fiscal Council intended. For example, instead of the tax reform the Council proposed, which not only increased the VAT but also decreased the fiscal burden on labor, the Government proposed a somewhat smaller VAT increase but without reducing the burden on labor. The effects on increasing public revenues are very similar. There is even greater similarity between the Council and Government proposals for controlling pension and public wage growth. After the Council's report was published in May, inflation accelerated, so that given the inflation assumptions the

Council used in May 2012, the Government's proposed low wage and pension indexation at 2% in October 2012 and April 2013 is in practice equal to freezing.

What is missing, however is the third reform pillar—fiscal consolidation—which the Council considers the most important. To avert a crisis, the Government will have to rise to numerous challenges, which can only be done if certain unpopular measures are adopted. The May Council report identified numerous burning issues in Serbia that must be resolved if fiscal consolidation is to succeed. It is necessary to

- complete the restructuring and privatization of socially owned and other enterprises within the competence of the Privatization Agency (97,000 people are still employed by those companies).
- streamline the number of public sector employees (through layoffs).
- implement pension reform to make early retirement more difficult.
- establish a sustainable system of fiscal decentralization.
- improve the system and significantly reduce the level of state subsidies.
- restrict the amount and purpose of state guarantees for borrowing by other legal persons.
- Consolidate various budgetary agencies and streamline their "own revenues".

So far only one of these proposed measures has been incorporated into the supplementary budget with changes announced in the legislation – the one that refers to the operation of agencies and budget beneficiaries with own revenue – which the Council obviously supports. Nothing seems to have been done about most of the other measures, which are probably even more important for averting a crisis. The supplementary budget for 2012, as well as the first announcements for 2013, even propose to increase rather than decrease certain budget items where savings (by eliminating subsidies) are absolutely necessary. This suggests a propensity for immoderate public spending, with a risk that this will annul the savings generated by tax increases and wage and pension growth restrictions.

SUMMARY OF ASSESSMENTS OF THE DRAFT 2012 BUDGET LAW INCLUDING FISCAL EFFECTS

The proposed amendments to the basic tax laws (value-added tax, excise duties, personal income tax, corporate income tax) are generally in line with good tax practice. The proposed amendments will stabilize public revenue at the level appropriate for Serbia's economic and social circumstances and also allow for partial reduction of the administrative costs for both tax authorities and taxpayers, as well making the tax structure more efficient. The Council has a negative opinion of the possibility of companies paying VAT liabilities upon collection rather than upon invoicing, because this option is not in line with good tax practice and complicate the tax system unnecessarily.

The proposed tax amendments will in the medium term bring in additional revenue of over RSD 40 billion in 2013 and increase public revenue by about 1.5% of GDP.[1] The proposed increase in the general VAT rate from 18% to 20% is expected to increase revenue by about RSD 32 billion in 2013. However, raising the threshold for inclusion in the VAT system; allowing small and medium-sized enterprises to pay their VAT liabilities upon collection instead of upon invoicing; and increasing VAT compensation to farmers from 5% to 8% will result in a (one-off) shortfall of about RSD 13 billion in 2013. Increasing the excise duties on tobacco products and oil products will increase revenue by about RSD 9 billion. Increasing the personal income tax rate on income from interest and dividends from 10% to 15% will raise revenue by RSD 6 billion, and the increase in the corporate income tax rate from 10% to 12% should raise revenue by about RSD 6 billion for April-December 2013. Eliminating the majority of tax exemptions and credits in the corporate income tax will bring in an additional RSD 2 billion or so in 2013. In the medium term, the increase in public revenue will be higher than in 2013, reaching about 1.5% of GDP, due to complete elimination of corporate income tax credits and disappearance of the one-off loss of revenue expected in 2013 due to the changes in the VAT system.

The proposed abolition or restriction of various forms of quasi-fiscal levies will contribute to a more efficient business environment and more equal treatment of

[1]This assessment does not include the effects of abolishing quasi-fiscal charges, considering that not all relevant information on this is yet available. In any case, the aim should be to ensure that abolishing these charges is revenue-neutral, particularly at the republican level.

economic actors. Many current quasi-fiscal charges are set arbitrarily (as an absolute nominal amount or as a percentage of a taxpayer's turnover) and are not in line with the economic power of taxpayers. Hence, quasi-fiscal charges often impose a disproportionately large burden on small and medium-sized enterprises and are a barrier to new players entering the market. However, because successful elimination and restriction of quasi-fiscal charges will require systematic efforts in the next few years, the Fiscal Council is unable to provide a final assessment of this segment of the tax package. It is certainly a step in the right direction but will require perseverance and consistent implementation in the next few years. Certainly, however, the shortfall of budget revenue that will be created by abolishing quasi-fiscal charges should be compensated primarily by reducing non-productive expenditure so as to strive for a revenue-neutral effect in abolishing quasi-fiscal charges.

On the other hand, the proposed amendments to the Law on Tax Procedure and Tax Administration and the Law on Fiscal Cash Registers will contribute to more efficient and more effective supervision of taxpayers and help reduce the administrative burden on entrepreneurs. From the fiscal point of view, the basic changes the amendments would make would be to abolish the obligation of registering sales revenue by means of cash registers for small entrepreneurs engaged in production who pay lump-sum taxes; restrict the option of prohibiting the performance of business activity by taxpayers who fail to duly register their sales revenue by means of cash registers; and expand the authority of the Tax Administration to supervise fiscal compliance—primarily by restoring its jurisdiction for first-instance tax misdemeanor procedure.

The changes in the budget treatment of budgetary agencies' own-source revenue are positive. The draft amendments to the budget system law, in fact, delete the concept of "own-source revenue" of budget beneficiaries, thus creating the preconditions for former own-source revenue to become general revenue of the budget, strengthening transparency and unity of the budget. As a consequence, the budget will be more transparent and preconditions will be created for improving the state of public finance. However, there is still a possibility that part of the funds of public fund beneficiaries will be kept outside the single Treasury account. The list of beneficiaries incorporated into the single Treasury account system (and thus also of those that remain outside the system) is determined by a special act, and it is not known to what extent the desired changes in management of public funds will actually be achieved.

The proposed amendments related to fees and charges are also positive. Considering that fees and charges have not been regulated, the provisions will lead to a more predictable and more stable business framework, abolish the autonomy of government authorities to determine such levies, and lower the burden on the economy and citizens.

Limiting indexation of wages and pensions to nominal 2% will result in savings. A change in the fiscal rules is planned in relation to the growth in public sector wages and pensions (an increase of 2% in October this year and 2% in April 2013); this should save about RSD 30 billion in 2012 and 2013.

Determination of the maximum public wage is planned. In addition to the Draft Law on Determining the Maximum Public Sector Wage, there are also plans for equalizing wages for ancillary and supporting technical jobs. Setting the maximum wage and the highest wage for ancillary jobs is justified; the way public sector wages are currently determined is extremely complicated, and it is possible for workers with equal skills and the same job description to earn very different amounts in different areas of the public sector. Exemptions are not fully transparent because the law does not apply to some institutions and to certain types of jobs. At the same time, there are no set criteria for the government authorities whose employees will be exempted from the provisions on maximum wages.

The "thirteenth pension" is not fiscally justifiable; it is also a poorly targeted measure, and it permanently increases the deficit. The program provides for an additional transfer from the republican budget of RSD 16,000 annually in four equal installments to all pensioners whose monthly income is lower than RSD 15,000. Because it raises public expenditure by about RSD 8 billion a year, spending in 2012 will rise by about RSD 4 billion. The proposed program does not take into account the financial status or income of other household members, and it does not cover almost 100,000 elderly people who do not receive pensions and who may be equally or more socially vulnerable.

The Law on Public Enterprises brings several improvements to corporate governance that may have positive effects on public finance. The procedure for public advertisement for electing managers of public enterprises is defined well, but it has yet to be seen how it will be put into practice. Certainly the process as described is a great improvement over current practice. However, there is still a possibility that the Government will have a pronounced influence on the election of managers. To reinforce the professionalization of public enterprise governance, an option of appointing at least some members of supervisory boards by public advertisement should also be considered. Another positive proposal is the requirement for such enterprises to disclose on their websites their Business Operation Programs. This is a very useful provision, which will encourage transparency and accountability in the operation of public enterprises.

Table 1. Basic Characteristics and Effects of Serbia's 2012 Legislative Proposals

Law	Characteristics	Assessment	Fiscal Effect
Law on Value-Added Tax	- Increase in the general tax rate from 18% to 20% - Increase in VAT compensation to farmers from 5% to 8% - Raise in the threshold for inclusion in the VAT system from RSD 4 million to RSD 8 million of annual turnover - Elimination of the threshold for voluntary inclusion in the system - Raise in the limit for monthly VAT payment from RSD 20 million to over RSD 50 million - Enabling SMEs with annual turnover of less than below RSD 50 million to discharge their liabilities upon collection of receivables rather than upon invoicing	- VAT increase is justified. - Raising the threshold for inclusion in the VAT system is justified. - Raising the limit for monthly VAT payment from RSD 20 million to over RDS 50 million is in line with good tax practice. - Enabling the discharge of VAT liabilities upon collection rather than upon invoicing is not in line with good tax practice and complicates the tax system unnecessarily.	-Additional budget revenue from VAT rate increase amounts to about RSD 7 billion until the end of 2012 and about RSD 32 billion in 2013 -The burden from the general VAT rate increase from 18% to 20% will be borne by consumers, with wealthier households bearing a somewhat heavier burden -VAT upon collection instead of upon invoicing, raising the threshold for inclusion in the VAT system, and raising the VAT compensation to farmers will depress revenues by about RSD 13 billion in 2013.
Law on Excise Duties	- Rise in specific excise duty on tobacco products from 33 dinars to 43 dinars per pack (45 dinars after July 1, 2013)	- Increase in excise duties on tobacco products is justified. - Reduction of gap between the amounts of	-Proposed changes in the excise system should raise public revenue by about 0.25% of GDP a year

	- Reduction in proportionate excise duty amount from 34% to 33% - Excise duty on unleaded petrol held at 49.6 dinars per liter; increase in excise duty on gas oils from 37 to 42 dinars per liter and on LPG from 18 to 30 dinars per kilo - Partial refund of excise duties on gas oils and LPG for the transport service sector - Calculation of excise duties on coffee in absolute nominal amount per kilo of net mass	excise duties on different oil products is in line with good tax practice and harmonizes with EU directives. - Refunding the excise duty on oil products for the transport industry will create distortions in the economy. - The proposed change in the method of calculating excise duties on coffee is in line with European practice.	
Law on Personal Income Tax	- Increase in the tax rate on income from interest, dividends, and capital gains from 10% to 15%	- Increase in the tax rate on income from interest, dividends, and capital gains is justified	- About RSD 6 billion in 2013 and about 0.15% of GDP annually in the medium term
Law on Corporate Income Tax	- Increase in the tax rate from 10% to 12% and abolition of most tax credits and exemptions	- Proposed increase in the nominal CIT rate from 10% to 12% is justified and will not undermine the competitiveness of the Serbian economy. - Abolition of the majority of CIT credits and exemptions is justified and desirable.	-Tax rate increase should bring in an additional RSD 6 billion or so in 2013 -Abolition of tax exemptions and credits will add budget revenue of about RSD 2 billion in 2013.
Law on Republican Administrative	- Abolition of seven local fees - Partial abolition and	- Abolition of local fees is justified. - It is necessary to aim for	- Estimated reduction of revenue of local self-government units

Fees and Law on Local Self-Government Financing	restriction of local signboard fee and restriction of maximum motor vehicle fee - Abolition of the republican administrative fee related to the registration of foundations, etc,, and to requests for vehicle registration certificates, etc.	revenue-neutral effect of abolition of quasi-fiscal charges, particularly at the republican level.	in 2013 due to the abolition of municipal fees, signboard fees, etc. is about RSD 5 billion.
Law on Tax Procedure and Tax Administration and Law on Fiscal Cash Registers	- Abolition of obligation to register sales revenue by means of cash registers for small entrepreneurs engaged in manufacturing and paying lump-sum tax - Restriction of the possibility of prohibiting business operation of entrepreneurs who failed to register their sales revenue by means of cash registers - Increase in the authority of the Tax Administration to supervise compliance	- Proposed legislative amendments are good and will contribute to better supervision of taxpayers and reduction of the administrative burden on entrepreneurs.	
Budget System Law			
a) Systemic measures	- Deletion of the term “own source revenue” of budget beneficiaries - Fees can be introduced only by a law that prescribes the amount of fees or grants a right to an	- Budget transparency is increased. - Due to lack of precision, space is left for part of the funds of public fund beneficiaries to still ber kept outside the Single	-Savings based on the change in the concept of own source revenue amount to up to RSD 10 billion in 2013.

	agent to determine fee amounts , subject to prior approval of the ministry	Treasury Account. - Savings are generated based on the changed concept of own revenue. - The provisions related to fees and charges are positive.	
b) Public expenditure	- Changed rules on public wage and pension indexation: increases of 2% in October 2012 and in April 2013 - Planned budget reserve for EU development assistance management	- Corresponding savings are generated based on wage and pension indexation change.	-Savings in 2012 and 2013 related to 2% indexation of about RSD 30 billion
Law on Determining Maximum Public Sector Wage	- Determination of maximum public sector wage - Wages for ancillary and supporting-technical jobs equalized	- The highest public sector wages are equalized. - Wages of employees engaged in supporting jobs in the public sector are equalized. - Not all types of jobs are covered. - Exemptions are not transparent; there is a possibility of unfair regulation of wages in public enterprises and other legal persons.	
Government Resolution on the 13th Pension Program	- Pensioners with monthly income below RSD 15,000 to receive an additional transfer from the republican budget of RSD	- This increases the fiscal deficit. - The program arbitrarily determines the criterion according to which	- Annual cost for the budget of about RSD 8 billion -Increase in 2012 public expenditure of

	16,000 a year, paid in four equal quarterly installments	pensioners can be deemed socially vulnerable. - It does not take into account the total financial situation of the pensioners' households.	about RSD 4 billion