Republic of Serbia
Fiscal Council

OPINION ON FISCAL STRATEGY FOR 2013 WITH PROJECTIONS FOR 2014 AND 2015

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CONTENTS

INTRODUCTORY REMARKS

In this report Fiscal Council gives the opinion on the Draft Fiscal Strategy, which is in compliance with the Budget System Law. Also, the Fiscal Council has a legal obligation to submit an opinion on the Government's program of public debt reduction after the general government debt exceeds 45% of GDP and the government submits a program to reduce public debt. Since the Government's public debt reduction program is an integral part of the Draft Fiscal Strategy, in this report Fiscal Council also gives the opinion on the Government's program for the reduction of public debt.

Fiscal Council presented a draft of this document to the Ministry of Finance, so there is a possibility that the Fiscal Strategy will incorporate the Fiscal Council suggestions and recommendations. We find that the planned reduction of deficit defined in the Draft Fiscal Strategy in the medium term leads first to containing of the debt and to declining of the debt afterwards, but in order to achieve this goal a credible plan with specific objectives, instruments and time-scheduled plans is needed.

BASIC JUDGMENTS

The Draft Fiscal Strategy sets forth a reduction of fiscal deficit which will lead to halting the public debt growth and its fall in the medium term. The proposed fiscal strategy plans a deficit of 3.6% of GDP in 2013, 1.9% of GDP in 2014, and 1% of GDP in 2015. The deficit path has been defined in the manner designed to stop the growth of the public debt share in GDP at the end of 2013, and to lead to a drop in public debt/GDP ratio in later years.

A credible plan for public debt reduction is not only the Government's legal obligation; it is the condition necessary to avoid the public debt crisis. There is every indication that at the close of 2012 the public debt will exceed 60% of GDP, which is the public debt level at which occurrence of a crisis is highly probable for countries similar to Serbia. In order to avoid the public debt crisis, the Government has an obligation to prepare a credible plan for halting further growth, and then reduce the share of public debt in GDP. Only under such conditions will investors continue to lend money to the government as otherwise – should the public debt continue to rise in the future without reversal in the trend – it would become certain that at one point in time the government will not be able to service its obligations. Public debt reduction is also the Government's legal obligation taking into account that the Budget System Law lays down that the Government submits to the National Assembly, together with the next year budget, a program for returning the public debt to the legal limit of 45% of GDP.

Planned sharp reduction of the deficit in 2013 will be provided for by short-term measures – tax increases and limited wage and pension rise. Fiscal deficit is the basic force driving the public debt growth and only by its sharp reduction is it possible to reverse the trend of public debt growth. This is the reason why the Government has started since October 2012 (together with the budget revision for 2012) to implement the fiscal consolidation program – short-term measures were adopted on the budget revenues and expenditures side intended to significantly reduce the fiscal deficit in 2013. According to the plan, fiscal deficit is to go down in 2013 from 6.7% of GDP (from 2012) to 3.6% of GDP and will be accomplished mainly by the tax increase (VAT, excises) and limitation of the nominal growth of pensions and wages in the public sector. Actual fiscal deficit could, however, be somewhat larger in 2013 than planned, as there are certain risks of smaller revenues and of larger than planned expenditures, but there is no doubt that major portion of the planned deficit reduction will materialize in 2013.

However, significant deficit reduction will ensure the macroeconomic stability only temporarily, and a public debt crisis will still not be avoided. Avoidance of a debt crisis requires not only to stop but to fully reverse the trend of public debt growth. Accordingly, it will be necessary to continue after 2013 the sharp deficit decline both in 2014 and 2015. The deficits defined in the Draft Fiscal Strategy (1.9% of GDP in 2014 and 1% of GDP in 2015) are adequate for accomplishment of this objective. Accomplishment of such a path of the government deficit supposes, however, an extraordinary high adjustment of public finances, which will be a great challenge in the next three years.

It has been planned to reduce the fiscal deficit starting from 2014 exclusively by cutting public expenditures. According to the Draft Fiscal Strategy, the share of public expenditures in GDP should go down in two years only (2014-2015) by about 3% of GDP. The Fiscal Council supports the approach according to which the necessary reduction of fiscal deficit over the medium term will be accomplished by a decrease of public expenditures. We also believe that rational spending and decrease of discretionary government costs will not be enough to enable such huge savings. Rather, they can only be a product of implementation of comprehensive structural reforms in the domain of public expenditures.

However, the Draft Fiscal Strategy has not presented any program with which to achieve the planned sharp drop of public expenditures in the medium term. Structural reforms from the Draft Fiscal Strategy that need to lead to planned reduction of budget expenditures, are set too broadly, without concrete objectives and deadlines, and for this reason are not credible in our view. We have even noticed that expenditure limitations per ministries in the period between 2014 and 2015 are not consistent with the plan of public expenditures reduction. Namely, permitted expenditures of the republic budget beneficiaries in 2014 and 2015 are too large. They would have to be reduced relative to those envisaged by the Draft Fiscal Strategy and thus enable achieve the desired reduction of public expenditures in 2014.

The Fiscal Council, aware of the seriousness of the situation and urgency of starting the structural reforms, is by this report proposing to the Government a more detailed and broader list of concrete measures within structural reforms. The danger of breakout of a public debt crisis has not passed. In order to be avoided, of crucial importance would be to start comprehensive structural reforms in the first half of 2013. For this reason, the Fiscal Council is in the present Opinion on the Fiscal Strategy taking an attitude which is slightly more constructive and more pro-active than would be usual for this type of reports – by proposing new and by supplementing the already proposed structural reforms which the Fiscal Council deems necessary in 2013. Those proposals are presented in the „Structural Reforms“ chapter and relate to: the pension insurance system, employment and wages in the public sector, reform of state and public enterprises, subsidy and social welfare system, and establishment of a fiscally sustainable system of fiscal decentralization. Apart from these proposals, we believe that the Draft Fiscal Strategy needs to define more specifically the measures that will improve the system of public procurements, operation of the Tax Administration, education and healthcare system, etc.

Public debt will be returned to legal framework only in the long run. It is also important to mention that both the fiscal consolidation measures and return of public debt to legal framework (45% of GDP for Serbia) will require dedication to that target over a longer time period. Thus, public debt will with the highly restrictive fiscal policy in place return to the legal framework only around the year 2020 (may also be possible around 2018 with some methodological improvements of the national accounts statistics – see the public debt chapter). However, this is neither unusual nor specific for Serbia only. EU plan of fiscal consolidation implies return of public debt level below the limit of 60% by 2025.[1] The Fiscal Council’s view is that the economic policy course would not need to be significantly changed in such circumstances, either, because the sustainable long-term level of public debt for Serbia is around 35% of GDP.

[1] For more details, see *OECD* (2011), "*Restoring Public Finance*".

1. STRUCTURAL REFORMS

Structural reforms are necessary in order for fiscal deficit to be reduced after 2013, too. The Draft Fiscal Strategy stipulates a major deficit decrease in 2014 – from 3.6% of 2013 GDP to 1.9% of GDP – and then its additional decrease to 1% of GDP in 2015. Sharp cuts in public expenditures have been planned in order to accomplish these goals, since the Draft Fiscal Strategy does not envisage an increase of one of the more generous taxes in 2014 and 2015 (economically fully justified). Such an ambitiously designed plan cannot materialize without implementing comprehensive, politically probably not popular, structural reforms. On the other hand, their implementation will at the same time ensure a foundation for a high and sustainable economic growth.

It may take one or two years after the start of the reform implementation for the first significant fiscal results to be recorded. Accordingly, the reform needs to be launched during 2013. It means at the same time that structural reforms had to be thoroughly prepared and its details presented in the Draft Fiscal Strategy for 2013. We believe that sharp deficit reduction starting from 2014, which would be prepared in the described manner and planned, would be credible enough. Any other alternative that would imply postponement of a thorough preparation and implementation of a reform is too risky for accomplishment of the targeted fiscal deficit and avoidance of public debt crisis. Namely, planned fiscal adjustment from 2014 and beyond is according to all indications too large to be successfully accomplished by one-time and *ad hoc* measures. Therefore, if implementation of the reforms is overly delayed, planned deficit targets will most probably not be achieved, while public debt share in GDP will continue to increase, instead to fall, also in 2014. Also, viewed from the angle of political economy, a favorable period to start implementing serious reforms is the start of the new Government’s term-of-office.

Majority of the necessary structural reforms have been identified in the Fiscal Strategy Consolidation, but lack sufficient preparation. The Strategy defines the key areas and basic directions in which structural reforms need to be implemented (which can also be additionally expanded). However, it is necessary to provide a more concrete description of the measures to be implemented, define all Laws and Decrees that will be amended on that occasion, describe clearly and analytically the savings to be achieved and, as most important perhaps, define the clear timeframes in which all of the listed tasks will take place. Because of these shortcomings, the Draft Fiscal Strategy does not represent in our view a sufficiently good basis on which planned structural reforms are to be implemented.

The Fiscal Council is therefore proposing to the Government a somewhat more detailed and broader list of possible reforms that it holds to be crucial for accomplishment of planned fiscal objectives. In its Report to the Government we are also proposed concrete measures, timeframes and goals of the reforms (trying to avoid „general places“) which would in the Council’s view, if inserted, significantly improve the Draft Fiscal Strategy. Actually, the Fiscal Council acknowledges that the Draft Fiscal Strategy for 2013 with projections for 2014 and 2015 was prepared in a limited time period, simultaneously with the Budget for 2013, but also with a large number of the initiated fiscal consolidation measures – which was a very demanding task. Hopefully, its analyses will help improve the proposed document and also the planning of the fiscal policy in the medium term. The Fiscal Council also expects improvement of the Fiscal Strategy in the next year, within the deadlines set by the budget calendar, particularly in the segment which relates to structural reforms implementation.

Improving Pension Insurance System

In the first six months of 2013 will be necessary to adopt the amendments of the Law on Pension and Disability Insurance, which would define the factors of actuarial equity for pre- and post-regular age retirement. An employee who retires at younger age will, as a general rule, be receiving pension for a considerably longer time than an employee who retires at older age. It is for this reason necessary that actuarial equity factors (actuarial penalties) provide that workers who retire younger receive a proportionately smaller pension amount, and those who retire older receive a proportionately larger amount of pension, depending on how long they are expected to be paid the pension. Non-existence of actuarial penalties is the major parametric weakness of the Serbian pension system. Due to such weaknesses the system is unjust and expensive. Serbia is one of the few countries where actuarial equity factors have not been introduced at all. If we take into account that retirement in Serbia is possible many years ahead of the regular retirement age, it is easy to conclude that Serbian pension system is a negative European record-holder in terms of actuarial (in)equity at retirement at different ages. At the same time, the system is economically not rational, either, as it provides erroneous motivation for selection of the working age and decision when to retire. Namely, employees will be encouraged to retire earlier as they will be receiving the pension for a longer period of time.

The Fiscal Council is proposing a pension cut by about 6% for each year of retirement prior to regular retirement age, and/or increase by about 6% for each year of retirement after the regular retirement age. If implemented, these measures would help save about 0.1% of GDP in the first years of application, and would thereafter rise over time and be around 0.4% of GDP after fifteen years when full long-term effects of the system of actuarial equity factors will be reached. Data from previous years suggest that one half of old-age female pensioners and as many as three-quarters of male old age pensioners retire prior to regular retirement age. Further raise of regular retirement age is meaningless without the introduction of actuarial factors, as workers would be increasingly encouraged to retire without financial consequences before regular retirement age. It is also necessary to speed up the current minimum retirement age schedule from the age of 53 to that of 58.

Introduction of a gradual raise of retirement age for women is necessary to shorten the unjustified five-year difference between the retirement age of women and men. Proposed is a phased age raise by six months during one calendar year so that old age retirement for women at the end of the transitional six year-period is minimum 63. Demographic and social circumstances in the Republic of Serbia do not justify a lower retirement age limit for women against men – the age of 60 for women against 65 for men. Most developed countries have over the past years equalized the retirement age for men and women. Of the comparative countries that have had similar problems as Serbia, Bulgaria has recently adopted a solution according to which men retire at the age of 65 and women at the age of 63, while Poland opted for a more radical form – retirement age for men and women has been raised in phases to the age of 67.

In the medium run, implementation of an adequate system of automatic stabilizers will be necessary to adequately adjust the pension insurance system with demographic ageing of the population. In the period between the beginning of the 20th and 21st centuries, average life duration increased by about 10 years. These demographic trends were most often not followed by a necessary corresponding raise of the retirement age, while some countries would even introduce over years generous conditions for early retirement. However, the funding problems have forced numerous European countries to implement at the close of the 20th century and early in the 21st century the parametric reforms, such as the raising of the retirement age, in order to be preserved the stability and solvency of public pension systems. However, parametric adjustments of the pension systems account for unpopular social reforms which often cause political-social challenges and instabilities. Consequently, it is necessary to consider introduction of flexible legal mechanisms for automatic adjustment of basic parameters of the Serbian pension system, principally the retirement age, with demographic changes in the next years and decades. Similar measures were over the past years successfully introduced in a rather large number of European countries, including Sweden, Italy and Greece.

Reforming Wage and Employment System in Government Sector

The trend of wage increase in the public sector faster than envisaged by legal indexation must discontinue. Namely, from 2010 until 2012-end increase of public sector wages has been by 11.4% higher than envisaged by indexation according to law. The bad practice also continues in 2013 when wage indexation is envisaged by about 4.2% (2% in April and 0.5% in October), while the Law on 2013 Budget sets forth that the position from which wages are paid go up by as much as 7.6% (Table 1). Wage increase in excess of planned indexation is partly explained by the growth of employment, and partly by the career promotions of civil servants during the year. In our view, these factors can explain only a part of the increase, mainly because the employment did not significantly increase in this period, while career promotion of some employees coincides with retirement of other public sector employees – as retiring employees generally have higher wage coefficients than those who are only now being promoted; accordingly, it is realistic to expect that these two flows have a neutral impact on the wage bill growth.

Table 1. Wage Bill Growth in 2009-2013 Period (%)

	2010	2011	2012	2013
Nominal growth	2.1	11.2	10.1	7.6
Nominal growth according to indexation	0.0	6.0	5.9	4.2
Wage growth through indexation	2.1	5.2	4.1	3.4

It is necessary to sanction any wage increase above indexation and prevent abuses that lead to wage increase not in compliance with the fiscal rules. Namely, apart from employment and career promotions as a basis for the wage bill increase, we have noted the presence of some other wage increases beyond the fiscal rules and indexation that are envisaged by law. Thus, for example, in 2012 and in 2013 on the “social allowances for employees” position annually appears about 6 billion dinars of additional earnings of the Interior Ministry employees, which are in unjustified manner paid as social welfare. This particular program and other similar programs need to be immediately abolished because apart of being in contravention of the law, they endanger the budget system and compromise the overall program of fiscal consolidation.

By end of 2013 would need to be introduced a single system of wage classes (12 to 15) which would help resolve in a consistent and systemic way the issue of wage level for similar positions in different government and public services. Current legal framework for wage determination in public services is extremely complicated and has five different bases and around 600 different coefficients for different positions of employees in different sectors. Such a system is not equitable because workers with the same qualifications and the same job description earn wages that differ even several times in different parts of the public administration. Enactment of the Law on Determining Maximum Wage in the Public Sector („RS Official Gazette“, number 93/2012) is a positive step in the direction of introducing order in public services, but is not sufficient. It will be necessary to prepare in the course of 2013 the amendments of the law and define the single wage classes in order for such amendments to be inserted in the budget for 2014. At equalizing different wages for the same jobs in public service it will be necessary to also take care of the manner in which this equalization will be carried out. It would be optimal, in our view, to temporarily disallow the indexation and in some cases to immediately reduce the wages of those employees in public services who have wages higher than usual for the same jobs – or not to allow in any way any "upward" adjustment by raising the wages over and above the prescribed legal indexation.

It is necessary to develop in the course of 2013 a program of rationalization of employees in the public administration, including local self-governments. Hitherto policies of downsizing the number of public administration employees have been *ad hoc* and would generally emerge at the time of the budget adoption when the need for reduction of expenditures would arise. Such policies were neither rational nor efficient. Therefore, the lack of rationality and redundancies in some state and public services require a systemic solution. The World Bank (2009 and 2010) identified a significant surplus of non-medical staff in the health sector, unjustified increase of administration at the local level in the period between 2006 and 2008 (which we believe to have continued in the months that followed), as well as a large number of redundant workers in (primary) education because of the inadequate structure of primary education institutions, in rural areas in particular, which have not been adapting to the significant drop of enrolled pupils in the last two decades. Decrease in the number of employees in public administration in the medium term has to be a part of a plan and must not be pursued on voluntary basis. A credible plan of rationalization of the number of employees in public administration would result in significant budget savings and in raising the public administration efficiency. On the grounds of the World Bank analysis, the Fiscal Council estimates that the number of 440,000 employees can be reduced by at least 5%, mainly in the areas of education, healthcare, local governments and public services. Total savings of about 0.4% of GDP at annual level could be achieved by rationalizing the number of employees in government administration and public services.

Besides the surplus en employees, there are also pronounced problems due to inadequate allocation of workers within different sectors of the government administration and public services. Thus, for example, while redundant workers are present in local administration, among non-medical staff in healthcare and among non-teaching staff in primary education, in some sectors, such as the Tax Administration parts, there is a deficit of employees relative to comparable experiences from other countries. However, it is probable that the structure of employees in institutions like Tax Administration and Treasury does not correspond to the needs of these institutions. Rationalization in these and similar institutions (downsizing the network of branches, full shift to electronic documentation, etc.) would lead to enhanced efficiency and also eliminate the horizontal imbalances in the number of employees per institutions.

In the first half of 2013 is necessary to develop a comprehensive central register, i.e. establish the exact number of employees in government and public services in order to enable implementation of all planned wage and employment reforms, but also to ensure adequate and consistent implementation of legal regulations. Currently, there are no single records of the employed in government and public services. Instead, there is only a register of employees in the Republic administration and education, which is maintained by the Treasury Administration. However, this register only covers about 150,000 out of estimated 440,000 employees in the government administration and public services. Therefore, it is necessary to expand the coverage of the existing information system onto the employees in the remaining government sector – healthcare, police, military, public agencies. The only possible way for monitoring the employment structure in government and public services and ensure a consistent implementation of legal solutions and spending of budget funds for the defined purposes is to make a comprehensive inventory list and on that basis form an adequate database. Introduction of the central register would also enable rationalize the expenditures for temporary and *ad hoc* hiring of workers, as well as the expenditures for hiring staff associates based on a temporary service contract.

Reforming State-Owned and Public Enterprises

The envisaged amendments of the Law that are intended to limit the timeframe for completion of the restructuring on 30 June 2014 are good from the point of view of fiscal adjustment; however, in order for the program to be credible, the bulk of restructuring needs to be completed in 2013. Up to now, the deadlines have been set on several occasions for the completion of the 12-year long privatization. The Fiscal Strategy envisages adoption of an Action Plan by the end of the year. This Plan needs to define the future of about 600 enterprises undergoing privatization or restructuring. According to the concept proposed by the World Bank, all these enterprises can be divided into four groups. In the first group would be the enterprises which can be privatized rather easily. Their number is probably the smallest and, accordingly, the privatization procedure needs to start as early as possible. In the second group would be the companies that stand no chance for further operation, they cannot be privatized, but have a valuable property which can be sold in the market. The sale procedure of that property needs to start in 2013 and proceeds from the sale to be used for social programs for the employees of companies that would get bankrupt. The third group would consist of companies that cannot survive in the market as a whole, but some parts or production programs *do* have good market prospects. The parts of such companies need to be privatized, and against the rest bankruptcy proceedings need to be instituted. In the fourth group would be the enterprises which do not have any market perspective and do not have property which could be sold in the market. Bankruptcy proceedings would need to be instituted against them as early as in the first half of 2013 and subsidies from the budget abolished for them. Assets planned for subsidies would be reallocated for the social program to cover the workers of such companies, which would be combined with the assets from the transition fund. In this way, significant budget savings based on the cutting of subsidies would already be achieved in 2014. However, if in the first six months of 2013 there will be no results credibility of the program which stipulates that everything will be resolved by mid-2014 will be called into question.

It will be necessary to define during the first semester of 2013 the individual efficiency criteria for public enterprises in state ownership, in order to enable measuring of their respective performances. The high degree of inefficiency in public enterprises entails, on one side, large direct and indirect subsidies and, on the other, creates inefficiency and illiquidity in the entire economy (defaults vis-à-vis suppliers, non-settlement of utility and other obligations, etc.). In such a system, the price rise for services provided by public utility companies, which operate on the monopolistic market, will not lead to the desired effects, i.e. the rise of their efficiency. We nevertheless believe that in the case of Serbia the prices of public companies' services need to be raised as early as possible in order to be reduced the losses in such companies caused primarily by the very low level of prices. In parallel with determining the efficiency criteria further progress will be necessary in liberalizing the activities in which public enterprises operate, and which do not have the character of natural monopoly (production of electric power, transportation in railway traffic, certain public utility activities, etc.). In this way would increase the efficiency of the entire economy, a better quality of public enterprises' services would be achieved, financial discipline would be established, corruption would decrease, and the growth of economic activity and employment would be encouraged.

Reforming Subsidy System

The Fiscal Council welcomes the planned abolishment of direct and indirect subsidies to state-owned enterprises starting from 2015 and reduction of subsidies to local utility companies; however, the manner of how to achieve this goal is not clear. Namely, one cannot discern from the document how the subsidies for JP „PEU Resavica“ will be abolished (particularly when one takes into account the sum of 4.3 billion dinars approved in 2013). The Fiscal Strategy envisages that subsidies for the railways be limited at 0.5% of GDP per annum, which will already be the percentage approved for 2013. Apart from that, the Fiscal Council holds it necessary to change the structure and mechanisms for allocation of subsidies to the Railways of Serbia in terms of abolishing the subsidies for current operation (wages of employees) and increasing the subsidies for investment purposes – mainly priority projects (railways corridor 10, Belgrade–Bar railway line, etc.). Transformation of JP „Železnice Srbije“ into a joint-stock company during 2011 and formation of four subsidiaries within the company (for transport of goods, passengers, infrastructure management and property management) can serve as a good starting base for further reform of the enterprise. In the next step will be necessary to define the efficiency criteria for each of the four companies. In accordance with the efficiency measuring result will be necessary to draw up a plan and start rationalizing the railway lines network in the passenger and cargo traffic. Thereafter, the tempo of liberalization of passenger and cargo transport will need to be envisaged, while the infrastructure would remain in the hands of the government.

It is necessary to gradually reduce and eliminate the subsidies for investment and employment and to promote in parallel the conditions for investing and doing business so that a friendly business ambiance rather than government subsidies become the basic motivation for inflow of foreign direct investments. The subsidies would need to be decreased (for example, by 0.05% of GDP each year, starting from 2013) and, possibly, limited only to large investments which create positive effects on the rest of the economy. Moreover, they would need to be as much as possible in the form of implicit subsidies (through land assigning, etc.), and to a lesser extent through direct payments from the budget. Analyses will show whether these subsidies had a positive result from the economic growth and employment growth point of view in the previous period, but we believe that such programs are not fiscally sustainable nor are economically desirable in the medium term. First and foremost, according to the World Economic Forum Report Serbia holds the 95th place in terms of competitiveness, below almost all countries in the region. Attempts are being made to compensate the constant fall in the competitiveness of Serbia's economy (from the 88th place in 2009 to 95th in 2011) by large direct (for example, payment from the budget for each newly-employed worker) and indirect subsidies (for example, exemption from payment of the profit tax, etc.). Instead of that, structural reforms need to be carried out in the area of business ambiance improvement. Some of such reforms include continuation of the guillotine of regulations, increase of efficiency in the domain of building industry (for example, slashing the number of days and the number of procedures for getting a building permit), more flexibility of the labor market, protection of competition and further abolishment of quasi-fiscal regulations, which will contribute to creation of a more friendly ambiance for investing in Serbia.

It is necessary to analyze the effects of agricultural subsidies on the development of this branch of the economy and consider abolishment per hectare, and replace them with a more efficient mode of funding the agricultural production. Subsidies need to result in increased efficiency in production and must be fiscally sustainable. As subsidies per hectare do not increase efficiency of agricultural production (investment is financed and not the result) and are not fiscally sustainable (there are not enough assets for covering all potential beneficiaries), the Fiscal Council thinks that they need to be replaced with another form of funding. Namely, the funding per hectare accounts for about 80% of all subsidies in agriculture. Investment is subsidized (for example, fertilizers per hectare, seeds for sowing, fuel, etc.) and not the result, which is contrary to the objective of increasing the economic efficiency in agriculture. Also, the number of beneficiaries in this scheme is hard to envisage. Accordingly, subsidies can easily overshoot a planned agrarian budget and create liabilities that were not foreseen. In order to limit the number of beneficiaries, the government has been intentionally introducing over time various additional criteria in order for the system to be more complicated and the number of beneficiaries smaller. According to the World Bank estimates, such a situation resulted in having only 20% of the total number of agricultural holdings which are using the subsidies per hectare. This particular fact in combination with frequent modifications of the agrarian policy objectives and modes for their accomplishment is creating uncertainty on the side of farmers who cannot plan a multiyear production. The Government's argument offered in favor of subsidization per hectare is the EU practice. However, the purpose of this type of subsidization in EU, when it was introduced in 1993, was quite different. It was introduced with the purpose of compensating the decline in market prices of agricultural commodities due to the flurry of the world competition, while EU is now trying to decrease this form of subsidies. Accordingly, Serbia's priority needs to be to subsidize the result of the production and raise competitiveness through investment in equipment, machinery, foundation stock, knowledge and technology.

In order to have in place a more transparent system of planning, subsidy award and control of subsidy spending, the Fiscal Council is proposing that the programs to be subsidized are an integral part of the Budget Law. Namely, the subsidies in the budget are currently shown in the manner that within a certain budget section is envisaged a certain amount for subsidies, and their purpose is later defined by a Government's Decree. In this way frequently happens that certain programs get abolished and assets envisaged for them spent for some other programs. This further entails earmarking of additional assets after the budget revision in order for all programs to be implemented during the year (the example of FIAT in 2012). Our proposal is to have a detailed table to include all programs and assets to be earmarked for them which would be a separate article of the Budget Law. On the other side, it is necessary to envisage submission twice a year of line ministries' reports to the Government on the manner of distribution and effects of the awarded subsidies. The Government would once a year inform thereof the National Assembly, i.e. the relevant Economy and Finance Committee. Needless to say, this system needs to comprise not only direct subsidies from the budget, but also those provided through the Development Fund and other government institutions.

It is necessary to clearly and precisely limit the issuance of new guarantees at annual level with the legally set limitations of the purposes for which a government guarantee may be issued. The limitation of new issued guarantees is presented in the Draft Fiscal Strategy only as an assumption in the analysis of the basic scenario for the public debt trend. The Fiscal Council holds, however, that limitation of guarantees needs to be defined as one of the basic assumptions and a condition for preparation of the budget in the years to come. There are two basic limitations with respect to the guarantees that would need to be complied with on that occasion. The first relates to the total amount of new approved guarantees during one or several years – which must be defined in the manner that will not endanger the sustainable public debt trend.[2] The second necessary legal limitation would relate to the purpose for which a guarantee is issued. Namely, issuance of government guarantees for borrowing is justified for the Fiscal Council where the government's interest in guaranteeing a borrowing is absolutely clear – for example, for important infrastructural projects that have passed through prior prioritization, selection and analysis among the various offered. It is necessary to abolish by law the earlier practice of granting guarantees to public enterprises for their credits taken for liquidity, refinancing of the existing liabilities and purchase of goods and services as they actually represent an indirect government subsidy to a company and indicate inefficient management of the state-owned property. It is also noteworthy that limiting the growth of guarantees would have a multiple positive impact on Serbia's economy over the medium term because, apart from exerting influence on the fall of the dangerously high public debt, it will also represent an indirect pressure on the government to implement more decisively the sizeable reforms in the area of public enterprises.

Fostering Social Welfare System

Social policy needs to be reformulated in order to be equitable and rational. Equitable social policy includes the programs geared to the poorest. On the other side, they need to be fully integrated in such programs. For example, the 13th pension social program covers the poorest pensioners only. However, they account for only 25% of the total number of the poor in Serbia.[3] Rational social policy cares that allocations do not endanger the budget stability. For example, in Serbia is about one-third of budget funds allocated for pensions and social welfare, which is not sustainable in the medium term. Accordingly, the existing funds need to be used more rationally.

[2] A slightly more demanding but more just definition of this first limitation could relate to annual increment of the guaranteed public debt, and not only the total amount of new approved guarantees – as it would in this way also include a schedule of planned repayments of the previously borrowed guaranteed credits. We have proposed such a solution in our Report of May 2012.

[3] Source: Republic Statistics Office, „Studija o životnom standardu" ("Living Standard Study").

In the course of 2013, social cards will need to be made so as to finally determine who the poorest strata of the population are, and thus make them focus on them. Fiscal consolidation achieved through tax increase and administratively controlled process on one side, and real wage and pension decrease, on the other, will result temporarily in additional deterioration of the living standard of citizens. Social pressure will be strong, and above-average burden of consolidation would be borne by the public sector employees, which is justified from economic point of view since wages in the public sector are higher than in private and the risk of losing the job is smaller. Making of social cards would help that social aid come to those who are really in need of such aid and would also result in a rationalization of the number of beneficiaries. In this regard, we estimate as good the proposed measure to rationalize the number of social welfare beneficiaries by checking their property status.

Involvement of local communities in the social care of the poor would be desirable, particularly after the amendments of the Law on Local Government Financing at 2011-end, so that they now dispose of much larger assets a part of which they could use for social welfare programs. Local communities could by their social welfare programs also comprise the citizens facing serious financial difficulties and not receiving any aid from the Republic budget. However, in this case would also be necessary to have the selectivity criteria in place and well-targeted beneficiaries so that the limited assets could go to those who need them most. In this context, the measures geared to help the families living in extreme poverty need to be prioritized against the measures not conditioned by the beneficiaries' economic standing.

Reforming Tax Administration and Curbing Gray Economy

Gray economy and tax evasion in Serbia represent an increasingly alarming issue and an increasingly large obstacle to a sustainable economic development. A decisive and systemic fight against gray economy, additionally pronounced over the past couple of years due to the economic crisis, has failed to take place. Curbing the gray economy is equally important both from the point of view of promoting the economic ambiance and establishing equality of citizens. One of the fundamental conditions for efficient functioning of the market is that the conditions for doing business are equal for all. This means *inter alia* that companies realizing the same income, turnover or having equally valuable property need to pay identical tax. The gray economy affects gravely the equality of the conditions for doing business because some economic entities pay all taxes, some pay them partially and some work completely in the gray zone. The pronounced presence of the gray economy in some activities discourages the entrepreneurship efforts in promoting technology and economic efficiency because the market competition result depends more on who is more successful in committing tax evasions than on who improves the business activity systematically. A similar situation also prevails in the case of citizens, tax evasions lead to significant horizontal inequality – citizens who receive the same wage and have equally worth property pay highly diverse taxes depending on whether and to what extent they work in the gray zone. This is why the systemic fight against gray economy and tax evasion must be priority in the next period both from the point of view of promoting the conditions for doing business and equal chances for citizens.

Systemic efforts in the field of curbing the gray economy and tax evasion can produce an increase in public revenues between 0.5 and 1% of GDP in the medium term. Tax revenues from curbing the gray economy can compensate the loss of revenues to be registered in the medium term due to rebalancing of the Serbian economy towards exports, and also bring additional net revenues. Although in the past decade no adequate research was made to quantify the size of the gray economy and possible additional budget revenues in this field, preliminary estimates and comparative data from comparative countries in transition in the region such as Bulgaria, Romania or Macedonia indicate that the volume of sales in the gray economy in Serbia could be between 30 and 40% of GDP, and/or additional budget revenues in this area could be at the level of 0.5 to 1% of GDP.[4] However, a precondition for the mentioned additional tax revenues to materialize in the next years is the implementation of a decisive and systemic fight against the gray economy and tax evasions, which would imply the radical changes in the functioning of the tax administration and a unanimous social and political support to the efforts in preventing the flagrant violation of the tax laws.

Establishing a Sustainable Fiscal Decentralization System

Multiple unilateral and unsystematic changes in the funding of local governments over the past couple of years have caused a large vertical fiscal disequilibrium among different local governments. By adoption of the Law on Local Government Financing at the close of 2006, a systemic framework for a predictable and sustainable financing of local governments in the Republic of Serbia was established to a large extent. However, the predictability of local government financing was affected as early as in 2009 when, due to the economic crisis, the Republic transfer to local governments was on a discretionary basis cut by 15 billion dinars (from 40 to about 25 billion dinars per annum). In mid-2011 were adopted the amendments of the Law on Local Government Financing which resulted in a total increase of available assets at local level by 40 billion dinars per year.[5] These additional assets were not accompanied by any increase in competences of the local governments. Consequently, in February 2012, the Republic government reclassified about 6,000 kilometers of regional roads into local roads and 4 billion costs of their maintenance were (formally) entrusted to local governments.[6]. There is no doubt that the local government was able to cover an additional liability of 4 billion dinars, given the extremely high increase in revenues due to legislative changes in 2011. Detailed projections of the Fiscal Council for individual municipalities and towns, which are given in the Appendix, show that even the undeveloped municipalities had the ability to absorb the additional costs for maintenance of reclassified local roads.[7] However, in response to the initiative of individual municipalities, the national government's budget proposal for 2013 was agreed to fully assume

[4] In broader public are often exaggerated the possible effects of curbing the gray economy on the growth of public revenues for two reasons: 1) unrealistic expectations that gray economy can be completely curbed, although according to international experiences the gray economy ranges between 10 and 15% of GDP in the most developed countries as well, and 2) ignoring the fact that the value added in the gray zone makes up the tax base, which is several times smaller than total sales in the gray zone estimated at 30 to 40% of GDP in Serbia.

[5] The share of local governments in wage tax revenues was raised from to 80%, and /or 70% in the case of the City of Belgrade, while total transfer assets to local governments were slashed from 1.7 to around 1.2% of GDP. For more details, see the Fiscal Councils' Report on Proposed Amendments of the Law on Local Government Financing dated 8 June 8 2011.

[6] The amount of additional assets for road maintenance did not correspond to the amount of additional revenues per individual municipalities, which has additionally deepened horizontal imbalances among local governments of a different degree of development.

[7] Additional obligations only in case Čajetina and Apatina were slightly more of the additional revenue that these two municipalities received legislative changes from 2011. year.

the cost of maintaining these local roads, which will further deepen the Republic deficit and increase the vertical fiscal imbalance between the national and local levels of government.[8]

Vertical fiscal imbalance (assets and relevant liabilities ratio) between the republic and local government levels amounts to 20 billion dinars in favor of local governments. One gets this vertical imbalance amount when, starting from the situation prevailing in 2007 after the adoption of the Law on Local Government Financing, into account are taken the discretionary decrease in the transfers to local governments of 15 billion dinars in 2009, increase of 40 billion dinars to local governments due to the legal modifications in 2011, and the expected drop in local revenues by about 5 billion dinars in 2013 as a consequence of the abolishment and limitation of the quasi-fiscal fees (fee for displaying a firm's name, fee for road vehicles, etc.) at local level.[9] Moreover, one needs to take into account that the 2007 Law on Local Government Financing, taken as a reference starting position, was relatively generous vis-à-vis local governments whose revenues rose between 2006 and 2008 by about 0.7% of GDP against the period between 2003 and 2005 that was assessed as „vertically balanced".[10] Also, as mentioned earlier, current financing of local governments also suffers from the horizontal imbalance issue to which have contributed the regressive effects of the distribution of wage tax revenues in 2011 as well as the *ad hoc* transfer of the obligation of funding the local roads in 2012.

With the exception of the City of Belgrade, all towns and municipalities in Serbia are in a much better financial standing than it would have been the case had the original Law adopted in 2007 remained in force – even when additional costs for road maintenance are taken into account. Simulation of the financial positions of the municipalities and towns, presented in the Attachment, shows that the City of Belgrade will in 2013 be in an almost identical financial position as if the initial 2007 Law had remained in force – in view of the fact that by the 2011 legal amendments only Belgrade was fully deprived of transfer assets from the republic budget and that it was determined that 70% of the wage tax would pertain to the capital, unlike the remaining local governments. On the other side, all other towns and municipalities have recorded an increase of their available assets both in absolute and relative terms. The highest increase of assets in absolute amount is recorded by (developed) towns, and it is precisely the segment with most room for savings of the transfer funds in the next period. Thus, if following the example of Belgrade other above-average developed towns in Serbia – the savings in the Republic budget would be over 7 billion dinars at annual level. Projections show that even after the abolition of transfer, the most developed towns such as Novi Sad, Niš and Kragujevac, had more funds available than would have been the case with the initial 2007Act. On the other side, several towns (Čačak, Kruševac, Pirot, Jagodina, Šabac and Sombor) would see partial reduction of funds in relation to the 2007Act. However, even in the case of these towns, the losses would be relatively modest, about 2 to 3% of the local budgets - which could be compensated by increasing the collection of property tax. In this way, the current shortage of funds at the Republic level would be reduced and additional (counterproductive) increase public

[8] Transfers to individual municipalities are envisaged in a total amount of 3 billion dinars for road maintenance (Attachment), as well as a transfer to JP „Putevi Srbije" of 0.9 billion dinars for winter maintenance of local roads. Initial estimates of the Ministry of Finance from March 2012 that about 10 billion dinars would be necessary for local road maintenance were actually overestimated. Namely, about 12 billion dinars used to be allocated yearly for total maintenance of the local road network, and as about 40% of road network was reclassified into local roads, the relevant liability is actually 4 billion dinars per annum.

[9]For more details concerning abolishment and limitation of quasi-fiscal fees at local level, see the Fiscal Council's Report on the Republic Budget Revision of 13 September 2012.

[10]For more details concerning establishment of vertical fiscal imbalance of local governments in the 2001-2003 period, see the relevant research *Levitas, A, 2005, "Reforming Serbia's Local Government Finance System", Journal of Public Administration, Vol. 28.*

spending at the local level would be prevented, before unsustainable system solution in this area is adopted and it enters into force.

Because of the inexistence of an adequate system of incentives a large number of local governments have failed over the past years to improve the property tax collection – which in accordance with the best international practice would need to be the key tax revenue of the local government level. In 2007, the competence for property tax administration and collection was shifted from the republic to local government level. However, the expectations that collection of this tax form would be promoted in this way did not materialize. Although some municipalities can boast of having markedly broadened the capture of taxpayers and registered property thanks to their systemic efforts (for example, by crossing the tax data with the data about electric power consumers or with relevant data from the real estate cadastre), the managing staff of most local governments have failed to decide to take radical systemic efforts in this area – mainly for the reason of political economy, in order to avoid to displease their electors.[11] The motivation to promote the property tax collection has particularly lessened after the local governments received last year the additional 40 billion dinars from the republic government. Relative the data from the census, and/or the real estate cadastre, the Fiscal Council can estimate that (over) 30% of housing facilities and real property in Serbia is not yet registered in this country for payment of the property tax. Also, the appraised base on which property tax is paid continues to be in a large number of cases significantly below the real market value in spite of sizeable increases over the past years.

The Fiscal Council suggests adoption in the course of 2013 of a systemic legal solution which will enable a sustainable and predictable system of local government financing in the next period. This systemic solution needs to remove the largest portion of 20 billion dinars missing in the Republic budget and establish horizontal balance among different local communities by appropriate redistribution of transfer assets. Further postponement to systematically address this issue will simply deepen the consolidated deficit of the general government level and increase the public sector's inefficiency – taking into account the increasing number of examples of irrational spending of surpluses of assets at the local level, such as the spending on setting up various agencies or significant increases of discretionary expenditures for goods and services.[12] Also, a future system will have to establish an appropriate system of financial sanctions (transfer or assigned assets reduction) in the case of municipalities which exploit inadequately their fiscal capacities in the area of property tax. Timely adoption of a systemic solution during 2013 is necessary not only to remove the existing fiscal imbalance and limit the excessive spending at local government level, but also to prevent further increase of

[11] The seemingly impressive nominal growth of revenues from natural persons' property tax of more than 150% in the period between 2006 and 2011 can be misleading. Namely, the key reason for this growth is not a radical increase of the number of taxpayers. Rather, the reason is the significant increase of appraised tax bases which were in this period, apart from regular adjustments for inflation and market trends, extraordinarily significantly raised on several occasions – by 30% in 2009 in accordance with the Ministry of Finance's recommendations, and in 2010 when the amounts of tax credits and deductions for depreciation were considerably reduced by law. On the other hand, the growth of property tax of legal entities was in the same period around 95%, primarily due to inadequate legal regulations which prescribe that legal entities pay the tax on the book value of real estate instead of on appraised market value as in the case of natural persons. This legal anomaly needs to be corrected as early as possible.

[12] Discretionary expenditures of local governments based on subsidies and procurement of goods and services in the first eight months of 2012 increased by as much as 25% in real terms against the same period of the past year. The worsening of the structure of expenditures at the local level can also be noticed in the period between 2004-2006, when the fiscal position of local governments was also relaxed due to increased revenues and absence of adequate increase of competences. For more details, see Šestović, L, 2008, „Makroekonomski i fiskalni aspekti decentralizacije" (Macroeconomic and Fiscal Aspects of Decentralization).

fiscal imbalance between the republic and local government levels. Namely, the law stipulates abolishment of the fee for building land utilization by end of 2013 (0.4% of GDP), while the destiny of the fee for building land development is uncertain (0.3% of GDP) amidst the efforts to eliminate and limit the quasi-fiscal fees. In the absence of a systemic solution, which will enable an adequate distribution of assets between the republic and local government levels, in accordance with the division of competences, it seems certain that the abolishment of these fees will additionally deepen the fiscal imbalance between the republic and local government levels, which will entail additional increase of the consolidated deficit and lessen the public sector's efficiency.[13]

It seems to be certain that in the case of Serbia and some other countries in transition the positive effects on economic growth will not materialize – unless an adequate system of fiscal decentralization appropriate for the social-economic circumstances in the Republic is established within a shortest time possible. It is noteworthy that although the economic theory speaks about the positive effects of fiscal decentralization on economic development, the results of empirical researches are not able to confirm (convincingly) the theory. Therefore, most empirical researches suggest a neutral or a slightly positive effect of fiscal decentralization on economic growth in developed countries, while empirical effects in the case of transition countries like Serbia – were most often negative in the previous years.[14] Various effects of fiscal decentralization are explained by the lack of adequate institutions and adequate planning of fiscal decentralization in the case of the countries in transition. Taking into account the earlier described *ad hoc* modifications in previous years and absence of a systemic planning and implementation of fiscal decentralization, it seems quite probable that in the case that the existing solutions remain further in force Serbia will also join the group of countries where fiscal decentralization is not followed by positive effects on the economic growth. Therefore, addressing the issue of decentralization is a systemic manner must be priority in the nearest future. At the same time, the situation in Serbia is even more serious because its fiscal decentralization has not been preceded (adequately) by political decentralization.

In the context of efforts invested in searching for a sustainable systemic solution, the Fiscal Council stands by its earlier recommendation that the share of local communities in the wage tax would needs to be reduced from 80% to the originally established 40%, while transfer assets would be mostly established in accordance with the original legal formula from 2007. If, due to political-economic factors the reduction of local government's share in the wage tax is not possible, the Fiscal Council proposes a systematic change of the formula for determination of (non-specific purpose) transfer assets – by reducing the total amount of the transfer by about 0.5% of GDP and distributing the assets among municipalities more progressively against the original distribution from 2007, so as to be offset the regressive effects of the increased share of wage tax revenues. Another solution that can also be applied in combination with the reduction of transfer assets is the shift of certain competencies from the republic to the local government level. However, any shift of new competences to local governments requires time for detailed planning and adequate preparation so as to be avoided the negative experiences from this year with the (unsuccessful) attempt to shift the competences for local roads' maintenance. In any case, any systemic solution to be adopted in the forthcoming

[13]Financing of the Autonomous Province of Vojvodina will need to be addressed systemically in the next period. This topic is not in the focus of our analysis as this issue is not currently a direct source of fiscal imbalance.

[14]For more details and a list of relevant theoretical and empirical references, see Arsić, M., 2011, „Analiza predloga o povećanju učešća lokalnih zajednica u porezu na zarade" (Analysis of the Proposals for Local Governments' Increased Share in Wage Tax).

period must neutralize the loss of about 20 billion dinars at the Republic level to the greatest extent and also include a planned abolishment of the fee for building land utilization and possible abolishment of the fee for building land development in the manner which will in no way additionally deepen the republic budget deficit.[15]

[15] The Law on Planning and Construction envisages integration of the fee for building land utilization with the property tax, while the Law on Public Utility Activities envisages replacement of this fee with introduction of a utilities fee.

2. OPINION ABOUT THE PROJECTION OF PUBLIC REVENUES AND PUBLIC EXPENDITURES[16]

It is a good idea to plan the deficit reduction starting from 2014 (deficit of 1.9% of GDP in 2014 and 1% of GDP in 2015) exclusively by decrease of expenditures and not by further increase of revenues. The Draft Fiscal Strategy defines that the share of public expenditures in GDP drops significantly after 2014 and the share of public revenues remains similar relative to 2013. The Fiscal Council supports such an approach to the necessary deficit decrease over the medium term since a successful fiscal consolidation can be founded only on the reforms and drop in public expenditures, and not on further increase of public revenues. We have recommended this approach also in the Draft Fiscal Consolidation Measures published by the Fiscal Council at the close of May 2012.

Projection of total public revenues trends is satisfactory. The Draft Fiscal Strategy plans a slight decrease of the share of public revenues in GDP until 2015 against 2013 by 0.5% of GDP, which basically is the result of the fall in non-tax revenues based on bankruptcy of socially-owned enterprises. Excluding this effect, the share of public revenues in GDP remains unchanged against 2013. The Fiscal Council takes this projection as realistic but also believes that some specific, minor adjustments need to be made. Namely: 1) the Fiscal Council holds that it is necessary to envisage either a drop in revenues based on planned abolishment of the fees for land utilization in 2014 or provide a detailed explanation of how these revenues will be made up for; 2) it expects the share of VAT revenues to decrease in general case faster relative to the plan due to the rebalancing of the economy geared to larger share of exports and investment, and smaller share of spending – which is the tax base for VAT. However, it is possible for the VAT share in GDP to temporarily go up insignificantly in 2014 due to finalization of the one-off impact from 2013 (VAT collection upon realization, extension of the collection deadlines, etc.), which is not set forth in the Draft Fiscal Strategy, either, and 3) it holds that it is necessary to plan, explain and include in the estimate the increase of certain tax revenues that have thus far not been exploited in their full capacity – such as the property tax.

The Fiscal Council believes it was necessary to envisage even more sizeable decrease of current expenditures so as to ensure the room for a higher growth of public investments. The Draft Fiscal Strategy plans for the period between 2013 and 2015 a drop in the share of current expenditures in GDP by 2.9 p.p., while the share of investments in GDP would remain unchanged (3.8-3.9 % of GDP). In its view, for countries with the level of development similar to that of Serbia it is economically justified to have public investments at the level of about 5% of GDP, which is not set forth by the Draft Fiscal Strategy. The room for an increased share of public investments in GDP needs to be ensured by additional savings based on a larger than planned drop in current public expenditures, in order not to overshoot the framework of planned fiscal deficit reduction. Additional decrease of current expenditures (relative to the plan from the Draft Fiscal Strategy) can be found on the position of expenditures for employees by

[16] The Fiscal Council will present a more detailed opinion about the public revenues and public expenditures trends in 2013 in its report relating to the Law on 2013 Budget, while in the focus of this report is only the analysis of the projections referring to the medium term.

rationalizing the number of employees (about 0.5% of GDP) and additional decrease of subsidies.[17]

The biggest deficiency of the Draft Fiscal Strategy, in view of the Fiscal Council, is the fact that decrease of public expenditures has not been planned in a credible manner, and is not even supported by a three-year plan of expenditures of individual budget beneficiaries. In order for the plan of decrease of public expenditures by 2015 to be credible, the Draft Fiscal Strategy should have presented in a more detailed manner the reforms to enable accomplishment of this goal: a more specific definition of the concrete measures such reforms involve, the Laws that need to be amended and the timeframes in which it will materialize – for which the Fiscal Council gave its concrete proposals in the preceding chapter of this paper. It is also noteworthy here that the three-year plan of expenditures of individual budget beneficiaries from the Draft Fiscal Strategy would need to be made compliant with the effects of implementation of structural reforms of public expenditures, but also with the objective of total deficit reduction.

Increase of expenditures of individual budget beneficiaries in 2014 and 2015 has been planned almost linearly against 2013, which is not consistent with the announced implementation of the structural reforms in the period under review. The Draft Fiscal Strategy envisages that expenditures of almost all ministries in 2014 go up by exactly 4% in nominal terms relative to 2013, and in 2015 by exactly 4% relative to 2014. The plan of structural reforms, which is in principle presented in the Draft Fiscal Strategy and stipulates a significant cut of some public expenditure items relative to others (subsidies, pensions, etc.) would have to reflect on the expenditure trends of individual budget beneficiaries. For example, the planned above-average decrease of the allocation for subsidies would need to reflect on the budget section of the Ministry of Finance and Economy and/or the section of the Ministry of Agriculture, which is not visible in the three-year plan of expenditure movements of individual budget beneficiaries where almost all budget beneficiaries after 2013 have the same increase of expenditures.

Expenditure movements of individual budget beneficiaries are not in line with total objectives of fiscal deficit reduction. It has been envisaged that total expenditures of the ministries and other republic budget beneficiaries increase in nominal terms in 2014 by 4.3% relative to 2013, and then to 4% in 2015. That would actually mean that in 2014 the expenditures would be approximately unchanged in real terms against 2013 because the inflation of 5% has been projected in 2014.[18] However, in order for fiscal deficit goals to materialize in 2014 (reduction of the deficit from 3.5% of GDP to 1.9% of GDP), and in circumstances of expected unchanged share of the Republic revenues in GDP, it is necessary that budget beneficiaries' expenditures drop in real terms by about 3% (and/or have a nominal growth of only 1%).[19]

Effects of deficit reduction resulting from implementation of fiscal consolidation measures are presented selectively. The Draft Fiscal Strategy also presents the impact of fiscal

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[17] For more details, see the Fiscal Council's report: „Predlog mera fiskalne konsolidacije 2012-2016" (Draft Fiscal Consolidation 2012-2016 Measures).

[18] A similar situation would also happen in 2015 when the inflation is planned to be 4.5% and nominal growth of expenditures 4%.

[19] Theoretically speaking, it is possible to reduce the fiscal deficit of consolidated government without a real drop in the republic budget revenues in 2014, which can be achieved by revocation of the amendment of the Law on Local Government Financing by which 80% of raised wage tax was allotted to local governments. In that case, the burden of fiscal adjustment would starting from 2014 be partly transferred to local governments and the republic budget, thanks to larger revenues, could preserve public expenditures at the level approximately unchanged in real terms. If the deficit reduction in 2014 supposes such a plan, this should have been mentioned in the Draft Fiscal Strategy while, to the contrary, the proposed limitations of expenditures per ministries are not consistent with the planned reduction of fiscal deficit.

consolidation measures on the decrease of the deficit. Those effects have been estimated to be worth 132 billion dinars. The Fiscal Council holds that these effects are overestimated and bases such view on the fact that only the measures which reduce the deficit are presented, or that measures adopted at the same time, sometimes even within the same laws and which influence on the deficit increase are not presented. Namely, simultaneously with the adoption of the increase of certain taxes (VAT, excises) also were adopted some reliefs, deductions, refunds, but abolished some para-fiscal imposts. Also, apart from the limitation of wage and pension indexation some expenditures relating to subsidies in industry and commerce, agriculture, 13^{th} pension pay-out, etc. were increased extraordinarily. The Fiscal Council holds that estimated effects of the fiscal consolidation measures would need to include all measures adopted by the Government and having fiscal implications, and not only those which have a bearing on the deficit reduction. In other words, the Fiscal Council believes that if as a part of the same package were also taken into consideration the measures by which the deficit rises, that would significantly diminish the effect of fiscal consolidation presented in the Draft Fiscal Strategy.

3. OPINION ABOUT THE PUBLIC DEBT REDUCTION PROGRAM

A part of the Draft Fiscal Strategy is also a program for public debt reduction. Public debt has exceeded the limit of 45% of GDP. Accordingly, the Government has a duty in conformance with the Budget System Law, to present to the National Assembly a program for public debt reduction together with the draft budget for next year. Preparation of a credible program for public debt reduction is not only a legal obligation of the Government, but is also economically indispensable because in the absence of debt reduction outbreak of a crisis in Serbia is highly probable. The program for public debt reduction is presented as a separate chapter of this document.

The Fiscal Council does not have any major comments with regard to the planned public debt (and fiscal deficit) path in the medium term, but emphasizes once again that accomplishment of these targets will be a great challenge. As the program of public debt reduction is an integral part of the Draft Fiscal Strategy, by presenting its opinion on this document the Fiscal Council also refers to the Government's program of public debt reduction. In broadest terms, the Fiscal Council does not have remarks with respect to the set quantitative goals for public debt reduction and the path of the Government deficit over the medium term arising therefrom. It is, namely, believed that the real challenge will be to reach the envisaged reduction of the fiscal deficit, as explained in more details in the chapters relating to structural reforms and the projection of public revenues and expenditures, and that the targets as such have been correctly set. In this part of the paper the Fiscal Council will focus on a more detailed assessment of the set quantitative targets of the fiscal deficit and public debt movements, without entering an analysis of the ways in which these targets will be accomplished.

The Program for public debt reduction is based on the fiscal consolidation measures. The basic driving force of public debt growth is the deficit of consolidated government. Apart from the fiscal deficit, government guarantees which in Serbia legally belong to public debt also exert a lasting, albeit significantly smaller, impact on the public debt trend. Other factors (for example, changes in the real exchange rate of the dinar) generally exert temporary influence on the public debt, and often are not under direct Government control. This is the reason why the Fiscal Council believes that the Draft Fiscal Strategy construes correctly that the foundation of the program for public debt reduction is the initiated fiscal consolidation – the objective of which is to slash the government deficit, particularly in 2013.

Quantitative targets for the period between 2013 and 2015, which involve reduction of fiscal deficit from 6.8% of 2012 GDP to 3.6% of 2013 GDP, 1.9% of 2014 GDP, and 1% of 2015 GDP are adequate. Almost identical deficit path was proposed to the Government by the Fiscal Council, so that the good news is that by the Draft Fiscal Strategy it has now become an official and public plan of the Government.[20] The Fiscal Council obtained the above path of fiscal deficit trend by taking into account the limitations relating to future movements of the public debt, and of fiscal deficit as well.

Planned deficit path (together with planned control of the growth of guarantees) is good as it ensures that the growth of public debt share in GDP will stop rising at the end of 2013, and start dropping from 2014 onwards. The basic economic indicator of public finances

[20] The only, almost insignificant difference, is that the Fiscal Council has proposed the deficit of consolidate government in 2013 of 3.5% of GDP, which was also originally accepted by the Government, but during the preparation of the 2013 budget the planned fiscal deficit was insignificantly increased (to 3.6%).

solvency in the future is the public debt path and, viewed from that angle, it was of crucial importance to ensure a decrease of the public debt share in GDP as early as possible. Namely, if the share of public debt in GDP is rising permanently, investors will very quickly see that public finances of the country are on the unsustainable path and will stop lending it the money – which is an introduction to public debt crisis. On the other hand, reversal of the trend of strong public debt growth requires a sharp cut of fiscal deficit where certain limitations also exist. Fiscal deficit decrease sharper than envisaged would undoubtedly reduce the public debt faster; however, it would not only be hardly feasible but also too risky with respect to negative impact on the Serbian economy. Therefore, halting the public debt growth at 2013-end, reducing its share in GDP starting from 2014 and an appropriate fiscal deficit path to enable achieving this goal as planned by the Draft Fiscal Strategy is in the Fiscal Council's view optimal for the plan of public deficit reduction.

The Fiscal Council holds, however, that fiscal deficit would need to be 0% of GDP in the period after 2015 and until the public debt's return to a lasting sustainable level. Although the Draft Fiscal Strategy relates to the period until 2015, the part referring to the program of public debt reduction presents a considerably longer path of fiscal deficit (until the year 2022 when the public debt has been estimated to return to the legal framework of 45% of GDP). The view of the Fiscal Council is that somewhat larger than planned reduction of fiscal deficit is required after 2015 in order for the public debt to return to the legal framework. That would mean reaching in 2016 a balanced budget (fiscal deficit of 0% of GDP) instead of the planned 0.7% of GDP, and then maintaining the reached balance in four to five years to follow. It is also noteworthy that the Budget System Law sets forth the target fiscal deficit of 1% of GDP in the medium term; however, as long as the fiscal rule on the public debt is breached it is necessary, in view of the Fiscal Council, to ensure a faster return of the public debt to legal frameworks by a slightly more restrictive fiscal l policy. Slightly more restrictively defined fiscal deficit than the one stipulated by the Budget System Law is also supported by the new EU rules which are similar to this proposal of the Fiscal Council (prescribing for the member states as targeted structural deficit the one below 0.5% of GDP).

Projections of public debt trends from the Draft Fiscal Strategy differ a little from the Fiscal Council's projections, particularly when end-2012 and end-2013 are concerned. In Table 2 are presented the projections of the public debt trends from the Draft Fiscal Strategy and the public debt estimate calculated by the Fiscal Council. Future trend of the public debt depends, besides fiscal deficit and guarantees, on the large number of unforeseeable factors. Therefore, it can never be projected fully reliably.[21] It was for this reason expected that the Fiscal Council projections differ a little from those from the Draft Fiscal Strategy. Still, the Table indicates that public debt/GDP ratio at the close of 2012 and also at the close of 2012 and at the close of 2013 is most probably overestimated, while the projected debt level thereafter is within the expected limits.

[21] Exchange rate of the dinar, economic growth, change of deposits, and the like.

Table 2. Projections of Public Debt Trend, 2012-2019 (% of GDP)

	2012	2013	2014	2015[1)]	2016	2017	2018	2019
Fiscal deficit (Draft Fiscal Strategy)	6.8	3.5	1.9	1.0	0.7	0.5	0.3	0.2
Public debt (Draft Fiscal Strategy)	65.1	65.2	58.7	58.4	56.6	54.7	52.7	50.8
Fiscal deficit (Fiscal Council)	6.8	3.6	1.9	1.0	0.0	0.0	0.0	0.0
Public debt (Fiscal Council)	61.0	62.6	57.6	56.6	54.8	52.9	51.0	49.1

1) For 2014 has been planned one-off abrupt drop of public debt because of large revenues expected from privatization. The Fiscal Council has in its projections adopted the Ministry of Finance and Economy's estimated impact of privatization revenues on public debt in 2014.

The Fiscal Council estimates that at the close of 2012 the share of public debt in GDP will probably be about 61% of GDP. However, according to the Draft Fiscal Strategy the public debt share in GDP will at 2012-end be as much as 65.1% of GDP. That would mean that with the officially estimated GDP the public debt would at the end of the year be over EUR 18 billion.[22] As the public debt level was around EUR 16.3 billion at end-September, including the non-guaranteed debt of local governments, the Fiscal Council estimates that it is not probable for the debt to rise by about EUR 2 billion by the end of 2012. As a part of the Government's borrowing in the period October-December[23] will be used for repayment of due government's liabilities, the planned fiscal deficit, contracted and announced government borrowing by the end of the year as well as the guarantees that have been issued indicate that total amount of the public debt by the end of the year will most probably not exceed the amount of EUR 17.5 billion. It thus follows that public debt/GDP ratio will be around 61% of GDP at the close of 2012 on condition that the exchange rate of the dinar is between RSD 115 and 117 per EUR 1.00.

Regardless of the planned reduction of fiscal deficit, the share of public debt in GDP in the course of 2013 will continue to rise, except in the case of strong, but economically undesirable, real appreciation of the dinar value. If the exchange rate against the EUR would during 2013 rise at the rate equal to that of inflation, the public debt/GDP ratio would at the end of 2013 go up against 2012-end by about 1.5 p.p. and would be around 62.5% (according to the Fiscal Council's estimate). The projections contained in the Draft Fiscal Strategy plan, however, with the same fiscal deficit and growth rate of GDP only an insignificant increase of the public debt share in GDP in 2013. In such circumstances, the Fiscal Council believes that in making the projections was most probably used the assumption of a strong real appreciation of the dinar during 2013, which is in the Fiscal Council opinion neither justified nor economically desirable in the next year.

Public debt projections in the Draft Fiscal Strategy contain certain inconsistencies that do not have major importance for the balance sheet, but need to be removed from the final

[22] Estimated public debt of 65.1% of GDP at the end of the year would implicitly be around EUR 18 billion if we take the exchange rate of RSD 120 for EUR 1.00. In the case of a slightly more realistic estimate of the RSD exchange rate at the year-end (115 to 117 dinars per EUR), the mentioned share from the Draft Fiscal Strategy would imply an absolute public debt amount of as much as EUR 18.5 billion.

[23] Eurobonds in the amount of about EUR 750 million, issued at the end of September, will be posted in public debt in October.

version of the Fiscal strategy. Thus, for example, the growth of the local communities' share in GDP is larger than their planned fiscal deficit. As local governments are not vested with the right to issue guarantees, and as their borrowing for the purpose of increasing deposits would not be economically justified, the Fiscal Council is of the view that public debt projection at local level needs to be harmonized with the trend of local governments' projected deficit.

Return of public debt to legal framework of 45% of GDP is not possible prior to 2018. After 2014, the Fiscal Council's projections are relatively similar to those from the Draft Fiscal Strategy (public debt level in the Fiscal Council's projections is lower by 2% of GDP, but the path is similar as in the Draft Fiscal Strategy, Table 2). It is, however, possible that nominal value of GDP will soon be adjusted in one-off manner upwards – because of the new assessment and inclusion of non-captured economy in GDP. Such adjustments have already been carried out in some countries in the region (Croatia, Bulgaria), and analyses indicate that the official figure of the GDP value in Serbia could be raised by 10 to 15%. If this happens, the share of public debt in GDP would drop by about 6 percentage points – for example, from about 51% of GDP to about 45% of GDP. It would then mean that with the mentioned change in the GDP value, the earliest possible return of the public debt to legal framework could be in 2018 or a little later.[24]

A sustainable long-term public debt level for Serbia would need to be about 35% of GDP. Targeted medium-term level of Serbia's public debt would need to be lower than the legal limit of 45% of GDP –about 35% of GDP. The lower target level of public debt would need to provide for the room that in crisis periods, when the government borrowing is rising, the public debt remain below the legal maximum, and/or remain in the zone where outbreak of public debt crisis is little probable. It is for this reason that the Fiscal Council believes that after a possible accomplishment of the public debt's legal limit it would be necessary to further apply for several more years a slightly more restrictive fiscal policy which will lead to sufficient reduction of the public debt.

[24] It is not unusual to make long-term and sometimes even decades-long plans concerning public debt trends and its return to legal frameworks. It has been estimated that return of public debt at EU level (without Greece) to the limits prescribed by the Maastricht criterion of 60% of GDP is expected to take place around the year 2025.

ATTACHMENT:

Differences of projected revenues from wage tax and non-specific purpose republic transfer in 2013, per towns and municipalities, between the 2011 legal solutions (80% of wage tax and 1.1% of GDP transfers) and the hypothetical situation that the 2007 Law had remained in force (40% of wage tax and 1.7% of GDP transfers), in million dinars.

Local government units	2007 Law	2011 Law	Difference	Cost for roads	Definite difference	Change against 2077 Law
Beograd	35,637	35,916	280	186	94	0.3%
Novi Sad	6,129	8,091	1,962	13	1,949	31.8%
Niš	4,007	5,096	1,089	25	1,063	26.5%
Kragujevac	2,430	3,060	630	5	626	25.8%
Aleksandrovac	273	423	151	4	146	53.6%
Aleksinac	580	880	300	12	288	49.7%
Aranđelovac	591	850	259	47	213	36.0%
Arilje	217	257	39	22	18	8.2%
Babušnica	181	318	137	17	120	66.2%
Bajina Bašta	276	409	133	49	84	30.4%
Batočina	123	210	87	0	87	70.3%
Bela Palanka	168	331	163	23	140	83.2%
Blace	144	245	102	6	96	66.7%
Bogatić	330	469	139	11	128	38.8%
Bojnik	145	256	111	38	73	50.2%
Boljevac	199	292	93	43	50	25.3%
Bor	558	775	217	58	159	28.5%
Bosilegrad	128	312	184	29	155	120.8%
Brus	205	300	96	11	85	41.3%
Bujanovac	440	658	218	23	195	44.3%
Crna Trava	41	107	66	11	55	132.4%

Ćićevac	111	183	72	0	72	64.7%
Ćuprija	328	505	177	16	161	49.1%
Čačak	1,401	1,733	333	29	304	21.7%
Čajetina	207	239	32	27	5	2.5%
Despotovac	289	405	115	32	83	28.7%
Dimitrovgrad	140	204	64	41	23	16.8%
Doljevac	186	313	127	2	125	67.0%
Gadžin Han	121	208	87	3	84	69.6%
Golubac	112	232	120	18	102	91.5%
Gornji Milanovac	570	787	217	96	121	21.2%
Ivanjica	370	626	256	47	209	56.5%
Kladovo	256	398	142	23	119	46.6%
Knić	164	250	86	9	78	47.4%
Knjaževac	423	652	229	47	182	43.0%
Koceljeva	150	232	82	26	56	37.5%
Kosjerić	141	186	45	26	19	13.3%
Kraljevo	1,563	2,250	687	21	666	42.6%
Krupanj	206	346	139	38	102	49.3%
Kruševac	1,418	1,903	484	20	464	32.7%
Kučevo	202	351	148	15	134	66.1%
Kuršumlija	266	467	201	55	146	55.0%
Lajkovac	249	366	117	8	109	43.9%
Lebane	259	422	163	30	133	51.3%
Leskovac	1,538	2,212	673	63	610	39.7%
Loznica	820	1,231	411	34	376	45.9%
Lučani	283	351	69	18	51	17.9%
Ljig	143	249	106	30	77	53.7%

Ljubovija	175	306	131	12	119	68.1%
Majdanpek	282	402	120	38	83	29.3%
Mali Zvornik	141	248	107	7	100	70.7%
Malo Crniće	138	237	99	21	78	56.5%
Medveđa	133	262	128	19	109	82.2%
Merošina	144	265	121	11	111	76.9%
Mionica	163	272	108	17	92	56.3%
Negotin	452	589	137	63	74	16.4%
Nova Varoš	225	344	119	20	99	44.0%
Novi Pazar	837	1,138	301	44	258	30.8%
Osečina	154	256	102	37	64	41.8%
Paraćin	536	776	240	15	225	42.0%
Petrovac	363	561	197	34	164	45.0%
Pirot	817	1,141	323	22	301	36.8%
Požarevac	1,161	1,575	414	19	395	34.0%
Požega	322	510	187	23	164	50.9%
Preševo	349	539	191	0	191	54.7%
Priboj	322	508	186	22	164	51.0%
Prijepolje	438	708	270	25	246	56.1%
Prokuplje	518	773	255	26	229	44.2%
Rača	139	238	99	10	88	63.3%
Raška	324	479	156	32	124	38.3%
Ražanj	123	224	100	9	92	74.3%
Rekovac	145	248	103	31	72	49.9%
Sjenica	327	541	214	48	166	50.8%
Smederevo	1,428	1,974	546	22	524	36.7%
Smederevska Palanka	552	799	246	26	221	40.0%

Sokobanja	194	277	83	19	65	33.4%
Surdulica	237	428	190	20	171	71.9%
Jagodina	838	1,156	318	20	298	35.6%
Svilajnac	260	402	142	19	123	47.3%
Svrljig	196	341	144	28	117	59.4%
Šabac	1,324	1,757	433	26	408	30.8%
Užice	1,153	1,533	380	22	358	31.0%
Topola	246	317	71	15	56	22.7%
Trgovište	84	230	146	39	107	126.9%
Trstenik	515	703	188	25	163	31.6%
Tutin	335	579	245	26	218	65.2%
Ub	283	394	111	36	75	26.5%
Valjevo	1,137	1,528	391	63	328	28.9%
Varvarin	192	316	124	16	108	56.2%
Velika Plana	433	688	255	4	252	58.1%
Veliko Gradište	194	322	128	25	103	52.9%
Vladičin Han	249	430	180	21	159	63.9%
Vladimirci	197	301	103	15	89	44.9%
Vlasotince	326	500	174	3	170	52.2%
Vranje	1,000	1,393	393	73	320	32.0%
Vrnjačka Banja	287	375	88	22	66	23.1%
Zaječar	729	1,000	271	82	189	26.0%
Žabari	140	215	75	5	70	49.8%
Žagubica	184	311	127	10	118	63.9%
Žitorađa	180	329	149	14	135	75.1%
Lapovo	83	126	43	0	43	51.2%
Ada	202	276	75	0	75	37.0%

Alibunar	231	352	121	21	100	43.4%
Apatin	497	545	48	12	36	7.3%
Bač	159	230	71	8	62	39.1%
Bačka Palanka	696	978	282	15	267	38.4%
Bačka Topola	408	554	146	0	146	35.8%
Bački Petrovac	186	263	77	0	77	41.4%
Bečej	499	730	230	1	229	45.8%
Bela Crkva	193	324	131	3	128	66.2%
Beočin	184	244	60	3	57	30.8%
Čoka	155	254	98	1	97	62.4%
Inđija	519	679	160	6	154	29.8%
Irig	133	186	52	14	38	28.7%
Kanjiža	294	372	78	14	64	21.7%
Kikinda	808	1,090	282	5	277	34.3%
Kovačica	284	413	129	0	129	45.3%
Kovin	385	570	185	7	178	46.3%
Kula	513	713	200	0	200	38.9%
Mali Iđoš	136	234	98	2	96	70.4%
Nova Crnja	117	193	76	7	69	59.3%
Novi Bečej	282	369	87	0	87	30.9%
Novi Kneževac	134	212	79	3	76	56.7%
Odžaci	345	519	173	6	167	48.4%
Opovo	106	180	74	8	67	63.1%
Pančevo	1,977	2,630	653	8	645	32.6%
Pećinci	238	283	45	25	20	8.2%
Plandište	158	264	106	0	106	66.7%
Ruma	603	839	236	5	232	38.4%

Sečanj	184	256	72	15	57	31.0%
Senta	324	408	84	2	82	25.3%
Sombor	1,110	1,500	390	15	375	33.8%
Srbobran	164	233	70	8	62	38.0%
Sremska Mitrovica	913	1,243	330	19	311	34.1%
Stara Pazova	760	1,010	249	8	242	31.8%
Subotica	2,005	2,507	502	17	485	24.2%
Šid	388	568	180	4	176	45.3%
Temerin	333	490	156	7	149	44.8%
Titel	170	274	103	3	100	58.8%
Vrbas	559	767	208	27	182	32.5%
Vršac	797	1,032	236	0	236	29.6%
Zrenjanin	1,723	2,217	494	3	492	28.5%
Žabalj	280	416	136	23	113	40.5%
Žitište	219	348	129	14	116	52.7%
Sremski Karlovci	138	158	20	0	20	14.1%
TOTAL	**106,931**	**136,337**	**29,406**	**3,041**	**26,365**	**24.7%**

Note: Total wage tax revenues are expected to equal 136 billion dinars in 2013. Expected wage tax revenues in each municipality is obtained by multiplying the total expected revenues with the share of wage tax revenues going to the respective municipality during the first nine months of 2012. Hypothetical projection of transfers to local governments in 2013, if the initial Law on Local Government Financing from 2007 had remained in force, was made by increasing the relevant amount of transfers from 2008 (the last year in which the original law was fully observed) by relevant changes in the nominal value of GDP (49%). Distribution of additional expenditures for maintaining 6,000 km of local roads across municipalities has been taken from the draft of the 2013 Republican budget law. These expenditures include 500,000 dinars for summer maintenance of 1 km of local roads and 150,000 dinars for winter maintenance. Simulations do not include the expected loss of about 5 billion dinars in 2013 due to abolishment of quasi-fiscal fees, the fee for display of a company's firm in the first place, because distribution of the loss of revenues per individual municipalities is still not sufficiently known. However, the Fiscal Council expects that the mentioned abolishment of quasi-fiscal fees will additionally emphasize the need for horizontal balancing of revenues between different municipalities and towns.