SUMMARY

Planned deficit reduction to 3.6% of GDP in 2013 represents a good reversal in fiscal policy, but it is most likely that it will not be fully successful. The Fiscal Council estimates that, with planned fiscal policy in 2013, state deficit will exceed the planned one (4.3% of GDP) by around RSD 25 billion, while there are certain risks to exceed it further. Furthermore, proclaimed settlement of the problem involving accumulated arrears will have an additional effect to state expenditure increase and thereby, to higher deficit. Bearing in mind all the above mentioned, fiscal deficit may even reach 5% of GDP, which is why we think it is necessary to prepare measures for deficit reduction and increase the control over budget expenditure significantly. We suggest several measures for fiscal deficit reduction. The most important and economically justified one is reduction of transfers to local self-government. So as to improve budget expenditure control, we propose defining and monitoring quarterly expenditure execution targets (especially procurement of goods and of services and subsidies) and conditional measures which would become effective automatically if quarterly targets are not achieved.

A strong reduction in the government deficit is planned in 2013 – from 6.7% of GDP in 2012 to 3.6% of GDP (from around RSD 220 billion to RSD 132 billion). The sharp deficit reduction is necessary in order to stop the almost uncontrolled public debt growth at the end of 2013. The public debt has doubled its share in GDP since 2008 (from 30% of GDP to 60% of GDP) and if a similar trend continues in 2013 as well, there will be a public debt crisis – macroeconomic instability, a decrease in GDP and a high increase in unemployment.

The deficit reduction in the short term will be achieved primarily by increasing taxes and reducing the increase in pensions and public sector wages. In October 2012, the general VAT rate was increased from 18% to 20%, and the excise duties on tobacco products and the personal income tax rate were increased. In addition to these measures, the increase in the corporate income tax from 10% to 15% will become effective in 2013. On the public expenditure side, the strongest austerity measure is the restriction of increase in public sector wages and pensions to 2% in October 2012 and 2% in April 2013. The tax increase and the real reduction of allocations for wages and pensions will ensure a deficit reduction by over RSD 100 billion in 2013.

The achievement of the planned budget deficit in 2013 will also require a sharp reduction of the expenditure for the procurement of goods and services and for subsidies. The tax increase and the restriction of increase in pensions and wages will not be sufficient to achieve the planned fiscal deficit in 2013 because – as one of the consequences of the rapid public debt increase – there will be a strong increase in allocations for interest payment in 2013. Thus, the interest expenditure will increase by more than RSD 25 billion in 2013 relative to 2012. For this reason, the planned deficit reduction in 2013 also requires sharp reduction in the expenditure for the procurement of goods and services and for subsidies. It is also worth reminding that such a high increase in allocations for interest additionally confirms the necessity of interrupting the public debt increase without delay, because the amount of interest paid has already exceeded the government allocation for the police, the military, as well as half the allocation for science and education.

The Fiscal Council believes that the reduction of expenditure for the procurement of goods and services and for subsidies has not been prepared well enough. The main mechanism for the reduction of expenditure for the procurement of goods and services, and partly for subsidies, is the restriction of allowed expenditure of government authorities for these purposes. Although the Fiscal Council welcomes the adoption of the supporting

measures provided for by the Government for this purpose (improvement of the control of expenditure of government authorities and abolishment of own revenue of budget beneficiaries), there is a noticeable lack of a clear plan with an explanation as to exactly which government functions and programs are abolished or significantly reduced and why. This plan is not only necessary for the credibility of the announced deficit reduction, but also in order to streamline public expenditures in an economically optimal manner – by reducing the ones that are least useful.

Therefore, the Fiscal Council estimates that the government deficit could exceed the planned level by around RSD 25 billion (0.7% of GDP) in 2012. Most of the planned deficit reduction will undoubtedly be achieved and this is due to structural measures relating to wages, pensions and taxes. We believe that the remainder of the anticipated savings is insufficiently well prepared and therefore more difficult to achieve. This will then result in an increase in the deficit relative to the plan and we estimate this increase at around RSD 25 billion. The consolidated deficit in 2013 would then amount to around 4.3% of GDP (RSD 156 billion) instead of the planned 3.6% of GDP (RSD 132 billion).

The planned deficit reduction in 2013 will be realized primarily at the republic government level. The republican budget is the largest part of the consolidated government budget and therefore the most important for pursuing the fiscal policy. The Draft Law on the Budget of the Republic of Serbia for 2013 stipulates that almost all of the needed fiscal adjustment is to be achieved at the level of the Republic, which will reduce its deficit from RSD 203.6 billion to RSD 121.9 billion. It is worth noting that, in addition to the republican budget, a reduction is planned of the deficit of local self-government units by RSD 8 billion and the deficit of the Roads of Serbia Public Enterprise by around RSD 2 billion in 2013, while the mandatory social insurance funds, in accordance with their statutory restrictions, are balanced both in 2012 and in 2013. Due to the key significance that the republican budget has for achieving fiscal targets in next year, but also due to the purpose of this document (we submit this Opinion to the National Assembly in the process of draft RS budget adoption), our analysis was mostly focused on the republican budget. Nevertheless, we dedicated special chapters in this Opinion to local self-governments and mandatory social insurance funds.

The revenue of the republican budget in 2013 is planned in an optimistic manner but it is still likely to be collected due to inflation acceleration. The Fiscal Council's analysis indicates that the public revenue increase in 2013 is basically overestimated, particularly in the corporate income tax and non-tax revenue items. However, the latest available data on inflation in September and expectations in the coming months indicate that it is very likely that inflation will be slightly higher than the one used for the preparation of the budget. Due to higher inflation than planned, the republican revenue will increase by around RSD 10 billion – approximately by as much as we previously estimated to be missing due to optimistic planning. Therefore, with a slightly changed structure in items, the planned total revenue of the republican budget in 2013 will most probably be reached.

The expenditure will most likely be slightly higher than the planned – by around RSD 25 billion, according to our estimates. We have already stated that we expect the envelope for the expenditure for the procurement of goods and services and for subsidies to be exceeded, because the measures for its reduction have not been prepared in sufficient detail. More specifically, in subsidies, we expect higher than planned allocations for subsidized liquidity loans, subsidies for support to foreign direct investments and probably also subsidies in agriculture – in the total amount of RSD 5 to 10 billion. There is no possibility of analysis by individual programs in the expenditure for the procurement of goods and services (including other current expenditure), so we opted to analyze the measures provided for in 2013 and the objective circumstances that will lead to its decrease (elimination of one-off costs - elections, transfer of own revenue to the budget and definition of priorities and the system of announcement of commitments and costs). In addition, we estimate that the allocation for interest payments will be at least 5 billion higher than those planned in the budget. We estimate that the expenditure for the procurement of goods and services in 2013, as well as subsidies, will exceed the plan by RSD 5 to 10 billion. A possible increase in expenditure for social security from the republican budget by RSD 1 to 2 billion should also be added to all this, because a significant part of these allocations is indexed to inflation, which would most likely be higher than the one used in the preparation of the budget.

There are additional risks of higher republican budget expenditure, and therefore also the deficit. No funds are planned in next year's budget for the Smederevo Steel Mill, although significant budget funds were allocated for this company in 2012. If this company is not privatized soon, certain expenses that are not planned by the Draft Budget Law will probably appear for it in 2013 as well. Furthermore, there already are public announcements that the one-off "Thirteenth Pension Program" will become a permanent right. The Draft budget only provides for the payment of the remaining two installments from this program, and so its continuation would lead to an increase in the deficit. Still, certainly the most dangerous risk is that there will be problems in the implementation of the announced indexation of wages and pensions by 2% in April, because it is possible that inflation will be much higher than expected until just a month ago when the indexation agreement was made. **It is particularly important to prevent the accumulation of new arrears by the government and resolve the problem of the existing ones**. The accumulation of arrears in government payments is dangerous in two ways – on the one hand, it endangers public finance, because, in the end, these outstanding liabilities most often become the public debt while, on the other hand, the government arrears increase the illiquidity of businesses, which do not receive funds for the product or service sold. In the past few years, there was a significant increase in government arrears, especially in health, local self-government and for the maintenance of road infrastructure. The total amount of these arrears reached more than 1% of GDP and now measures must be taken to solve this problem. A necessary prerequisite for this is to prevent the creation of new arrears in 2013 (and in subsequent years). The Fiscal Council therefore welcomes the announcement of a tighter restriction of payment periods, but also the introduction of additional measures for those budget beneficiaries in which we observed a systemic increase in arrears in the last few years (Republic Health Insurance Fund).

The existing arrears should be paid in a fiscally responsible and transparent manner. In terms of solving the problem of the existing arrears, we suggest the introduction of additional and specific rules:

1) We believe that a significant part of the burden of payment of the accumulated liabilities should be borne by those government authorities that accumulated the arrears in the first place. Unconditional financial rescue of certain government levels and budget beneficiaries by the Republic does not sanction their irresponsible management of their own finances and may lead to "moral hazard". So, in the case of local self-government units, we believe that the role of the republican government should not go beyond coordination and control, because now local self-government units have enough funds to deal with the problem of arrears by themselves. The arrears in health care (Republic Health Insurance Fund and hospitals) would most probably require certain government intervention, which should then be limited in amount and clearly conditioned.

2) The financial volume of the total government intervention (and therefore the increase in public debt) should be restricted in 2013 to maximum 0.5% of GDP. This means that, with the above transfer of the part of the burden to those that made the arrears in the first place, it

would be necessary to provide a discount of the existing liabilities and an optimal schedule of their payment through a negotiation process.

3) The payment of liabilities based on accumulated arrears should be included in the government deficit in 2013. The payment of debt based on arrears may be effected in two ways: by posting it “below the line” and without increasing the deficit, or by including it in the deficit. In both cases, the increase in the public debt would be identical. Since the goal of fiscal consolidation and deficit restriction in next year is to stop the public debt accumulation, we believe that it does not make much sense to increase the public debt based on borrowing for the payment of arrears and then not present this in the deficit. The inclusion of these payments in the budget increases the transparency of the whole process and we believe that it is economically correct.

If the accumulated arrears are cleared in 2013, it will be even more important to keep the remaining government expenditure under control. Based on the payment of arrears in 2013, the deficit could increase to around 4% of GDP. Otherwise, the deficit in 2013 could exceed 5 % of GDP, which we consider to be fiscally unsustainable. In addition to previously identified other risks and overly optimistic planning of certain expenditures, it is very possible that the fiscal deficit in 2013. and reached 5% of GDP. Therefore, it is especially important to keep the remaining public expenditure under control and not allow it to exceed the envelope in which it is planned.

Therefore, the Fiscal Council proposes additional measures in order to keep the deficit within the planned limits. We propose the following: 1) Reduction of transfers to local self-government units. The 2011 legal amendments provided local self-government units with around RSD 40 billion of additional funds at the expense of republican revenue. Having this in mind, it is surprising that additional transfers to local self-government units are approved from the republican level in 2013, in addition to the standard ones, this time for the maintenance of road infrastructure (in the amount of RSD 4 billion). The Fiscal Council believes that this additional transfer should be abolished immediately and then the amount of other, non-categorical transfers to local levels should be reviewed and reduced by around RSD 7 billion. 2) Review and abolishment of certain wasteful subsidy programs. The 2013 Draft Budget provides for a significant increase in subsidies for housing construction, commodity loans for Republika Srpska (computers, railway cars) and alike, and new programs are introduced (shipbuilding). We believe that it is necessary to review the justification of all these subsidies, select priorities and thus reduce the expenditure for subsidies and total public expenditure. 3) We believe that the unjustified payment of wage benefits to the employees in the Ministry of Internal Affairs, which is treated as welfare benefit for employees, should be reviewed or at least significantly reduced. RSD 7 billion is planned for these purposes in 2013 (of which, in our opinion, RSD 6.5 billion is unjustified).

Possible savings on capital expenditure would not be in accordance with good practice in public finance management. A reduction of the share of capital expenditure in GDP is planned already in next year, which we do not find appropriate for the level of economic development and the economic cycle in which Serbia is. We emphasize, however, that in the previous years, when a need arose for making savings during the year, they were found in reducing capital expenditure. Since already now there are risks of departure from the planned fiscal envelope, the opinion of the Fiscal Council is that it should by no means be allowed for the increase in current expenditure to be achieved at the expense of capital expenditure.

The Fiscal Council believes it is necessary to introduce additional control mechanisms for budget implementation. The Fiscal Council thinks extra guarantees are needed to prove that the Government will comply with the planned expenditure scale, i.e. no state body will increase their expenditure above their limits during the year – which used to be bad practice in the past. To that end, we consider it necessary to define and adopt quarterly expenditure execution targets. However, we would like to stress that, for sure, the best guarantee for fiscal plans credibility for next year would be a new arrangement with the IMF.

We suggest the definition of quarterly expenditure execution targets. Our analysis has shown that the risk of exceeding the planned fiscal envelope in 2013 is much higher on the budget expenditure side than on the revenue side. Therefore, we believe that the control of expenditure execution during the year and a timely prevention of its increase beyond the planned envelope will be of crucial importance in next year. To this end, we suggest that the Government define quarterly execution targets for total expenditure of the Republic budget, but also for the expenditure with a particularly high risk of exceeding the planned budget envelope – such as the expenditure for the procurement of goods and services and the expenditure for subsidies. We also believe that the position of government arrears should be included in the proposed quarterly budget execution targets in 2013 – so that the data on the arrears trend in 2013 would be visible and better controlled. We also suggest that the quarterly targets be agreed upon with the Fiscal Council, as well as that the Fiscal Council monitor their achievement and inform the public about it.

In case the quarterly targets are not achieved, we suggest defining the conditional measures that would automatically take effect. We consider it desirable also to define in advance the measures that would automatically take effect if the defined quarterly targets are breached. The conditional measures would bring additional credibility to the budget expenditure restriction. These measures could relate to the indexation of pensions and wages in October, the suspension of some subsidy programs or something else.