SUMMARY

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.

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