HIGHLIGHTS

Highlights 1. Scope, limitations and possible corrections of the agreement between Serbia and the IMF

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The three year agreement between Serbia and IMF, which entered into force at the end of February of the current year, includes three key components: fiscal consolidation, restructuring of state owned enterprises, privatization of former public enterprises and improvement of the stability of the financial sector. Signing the agreement increased the chances for the ambitious plans of the Government in economic policy and reforms to be achieved, and macroeconomic risks, such as the crisis of public debt and balance of payments crises, are substantially reduced. We expect that financial markets will react favourably to the signing of the agreement, and that the conditions of borrowing for the Government and companies from Serbia in international financial markets will improve. The consistent implementation of the agreement will benefit the business conditions and growth prospects as well as the gradual increase in foreign direct investments in Serbia.

The agreement, in addition to the fiscal and monetary policy measures, contains a number of structural reforms in the banking and enterprise sector. The reforms in the banking and enterprise sector have a dual purpose - on the one side they should contribute to establishing a macroeconomic stability by stopping the spillover of their losses to the state budget, while on the other side they should provide favourable conditions for economic growth. The agreement with the IMF is relatively detailed[2], it contains concrete measures at the level of individual enterprises, and also very detailed savings measures. Although, entering these details into the agreement indicates certain lack of trust of the IMF in the Government of Serbia, we estimate that such detail level is desirable because it reduces the space for feigning the reforms. The agreement contains relatively precise dynamics of the implementation of economic measures, and also regular quarterly audits of the agreement implementation are agreed, which significantly reduces risks of delays in the implementation of measures, their mitigation or remission.

Although the arrangement with the IMF covers a larger number of areas it, however, does not cover all reforms and policies Serbia needs to implement in the following years, nor is this its goal. Therefore the economic policy of the Government should not be reduced only to the implementation of the conditions given by the IMF. Besides the measures contained in the arrangement the Government should implement additional reforms which will improve the quality of the public administration, judiciary, cadastre, education, health, etc. Also, it is justified for the Government to prepare special sectorial development plans for activities such as agriculture, construction, IT sector, innovation enhancement, ecology, etc. In the agreement with the IMF there are no special limitation for the realisation of the mentioned policies, except the limitation that these policies cannot increase the fiscal deficit and the borrowing of the State. Besides reforms, antirecession measures should be implemented in line with the fiscal consolidation, such as the significant increase in public investments, while NBS should stimulate the credit activity of the banks.

Although the arrangement with the IMF contains a number of measures dedicated to the improvement of the economic environment, restructuring of the enterprises and the financial sector, we estimate that some measures of the fiscal consolidation are not contributing to the long-term growth of the economy and the development of the society, and also that in the agreement not enough attention has been paid to antirecession measures. From the standpoint of the economic growth and general development of the society we asses that the planned savings on subsidies are insufficient, savings on salaries of employees in the public sector are exaggerated and probably unachievable, while the growth of public investments is modest and that is why they remain on very low level in the entire period. Therefore, it should be justified to change the structure of the fiscal consolidation during the implementation of the arrangement, holding the approximately same goals of fiscal deficit reduction. In comparison with the current arrangement, subsidies would be reduced while the expenditures for employees and public investments would be increased.

Subsidies in Serbia for a long time now have been significantly higher than in other countries. During previous years, subsidies in the broader sense[3] in Serbia were between 3 and 4% of GDP, which is two or three times more than in other European countries. According to

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2 By details this agreement resembles the agreement between Serbia and Montenegro and the IMF for the period 2004-2006. The agreement was preceded by difficult negotiations, and trust of the IMF in the Government was very low, but the agreement itself was successfully implemented.

3 Subsidies in a broader sense include all types of state aid to the economy: direct budget subsidies, tax incentives, expenses from payment of guarantees, etc.

Table 1. Cost share of employees in the public sector in total GDP, in %

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	Average (2005-2009) -2014	Max-2014
Bulgaria	9,3	8,6	8,5	8,9	9,6	9,3	8,8	8,8	9,6	9,9	-0,9	0,0
Czech Rep.	7,3	7,2	7,0	7,0	7,5	7,2	7,0	7,1	7,2	7,1	0,1	0,4
Estonia	:	:	:	:	:	11,6	10,8	10,4	10,7	10,9		0,7
Croatia	11,2	10,9	11,3	11,2	12,3	12,2	12,4	12,2	12,0	12	-0,6	0,4
Latvia	9,5	9,4	9,9	11,4	11,9	10,2	9,5	9,1	9,2	9,4	1,0	2,5
Lithuania	10,3	10,4	9,8	10,6	12,7	10,9	10,2	9,7	9,5	9,6	1,2	3,1
Hungary	12,4	12,0	11,5	11,4	11,3	10,9	10,2	10,0	10,1	10,5	1,2	1,9
Poland	:	:	:	:	:	11,0	10,6	10,4	10,3	10,3		0,7
Romania	8,7	9,2	9,7	10,3	10,7	9,5	7,8	7,7	8,0	8	1,7	2,7
Slovenia	11,3	11,0	10,4	10,8	12,2	12,4	12,5	12,5	12,5	11,5	-0,4	1,0
Slovakia	7,8	7,7	7,2	7,4	8,5	8,4	8,2	8,1	8,5	8,5	-0,8	0,0
Average	9,8	9,6	9,5	9,9	10,7	10,3	9,8	9,6	9,8	9,8	0,1	1,0
Serbia	11,5	11,7	11,9	12,5	12,4	11,8	11,8	12,3	11,9	11,8	0,2	0,8

Source: Eurostat Ministry of Finance of Republic of Serbia

the agreement with the IMF subsidies will be relatively rapidly reduced in 2015 to 2.6% of GDP, and in the next two years a modest reduction to 2.4% of GDP should be achieved. The agreement for subsidies to remain at such a high level is probably a result of the fact that the Government was not prepared to commit to eliminate various types of subsidies for investments and employment, and it is possible that the high subsidies are in part the result of commitments given up to this moment. We estimate that it will be more appropriate for subsidies to be reduced also in the following years so that they are reduced to around 1.5% of GDP already in 2017. The elimination of subsidies would not have adverse effects on the level of investment and employment if the plans to improve the business environment would be implemented (reduction of administrative barriers, improvement of the work of courts, cadastre and state administration, build infrastructure, etc.).

In the agreement it is agreed to reduce expenditures on employees in the public sector from11.8% of GDP in 2014 to 8.3% of GDP in 2017 (in other words, from 10% to 7% of GDP according to the IMF methodology[1]), which is over 3.5 percentage points of GDP. Planned reduction of the labour costs would be achieved by reducing the salaries higher than 25 thousand by 10% (done in the last year), keeping the nominal wages at the fix level in the next three years (with the planned inflation of around 4% a year), and also reduction of the number of employees in the public sector by 15%. Real reduction of wages in the public sector, as a result of the last year's reduction of nominal wages and expected inflation devaluation, would amount to between 12 and 20%. Minimal real reduction of 12% would refer to salaries up to 25 thousand, while the maximum[2] real reduction of 20% would be achieved with employees whose salaries were reduced in the last year by 10%. Real salaries of relatively large number of employees in the public sector (teachers and professors in primarily and secondary schools, nurses and doctors, police officers, etc.) would be at the level below existential minimum, which would reduce the motivation to work, encourage different forms of "managing", while the most competent workers would leave the public sector or even the country.

Expenditures on employees in the state sector, without state owned enterprises, (so called general state), in the Central and Eastern Europe countries are in average 9.8% of GDP, where the lowest expenditures are recorded by Czech Republic (7.1% of GDP), and the largest by Slovenia (12.5% of GDP). While the expenditures on employees in public sector in Serbia in 2014 were significantly above the average of the Central and Eastern Europe countries (11.8% of GDP compared to 9.8%), the goal was set that in the course of three years it will be significantly lower than the average of this group of countries (8.3% of GDP to 9.8% of GDP). If the set goal would be achieved in three years the ratio of expenditures for public sector employees in Serbia to GDP would be among the lowest in the Central and Eastern Europe - Czech Republic (7.2% of GDP) and Romania have lower share (8% of GDP).

The number of employees in the public sector in Serbia amounts to 520-530 thousand, i.e. 7.3 employees per 100 residents, according to this data Serbia is above

1 The EU methodology in labor costs in the government sector includes contributions paid by the employee and also by the employer, while the IMF methodology includes only contributions paid by the employee. We use the EU methodology because of the comparison with other countries, and in addition to that Serbia switched to this methodology at the beginning of the year.

2 One part of the employees in the public sector had a greater decrease in wages because wages decreased in the second part of the year on the basis of the past work.

Box 1. Number and the structure of employees in the public sector in Serbia

In the last two years a considerable confusion was created regarding the number of employees in the sector of general state in Serbia (all levels of administration, education, health, justice, security, etc.) and the public sector (general government sector plus state-owned enterprises and banks). The number of 780,000 employees in the public sector was presented to the general public as a "discovery", calculated by adding approximately 250 thousand employees in the public enterprises, state-owned banks and the former socially-owned enterprises which are now owned by the state to the earlier known number of about 520-530 thousand employees in the sector of general government. Previous data include full-time employees as well as the employees on temporary work, based on service contracts, etc. Additional confusion is created by the fact that all public sector employees were declared as "clerks", therefore the state administration. However, about 60,000 people in total is employed in the national and the local administration, while others work in education (about 150,000), health care (about 125,000), security services (police, military and other - about 80,000), the judiciary (approximately 18,000) and other. Hardly could the term "clerk" be attributed to the majority of public sector employees (teachers, doctors, officers, judges, firefighters, researchers, developers, etc.).

Parallel to untrue data, the public was faced with claims from politicians, and even some economists, that in Serbia there is a huge parasitic public sector that employs far more employees than in other countries. In the largest number of cases these claims about enormous number of employees were not supported with statistical data, but were just based on real or fictional anecdotic examples. However, even when these claims were supported with comparisons with other countries, they contained rough methodological errors, such as:

a) the number of employees in the public sector in Serbia included the employees in state owned enterprises (including former public companies), while this was not the case with other countries,

b) the number of employees in the sector of the general state included all levels of the state (republic, social security funds, provinces and the local municipalities), while for other countries only data corresponding to the central state were used, without employees in local municipalities, provinces, and sometimes without the employees in the public health sector.

Comparable data which are presented earlier convincingly show that the number of employees in the public sector in Serbia in ratio to 100 residents is now already lower than the average in the countries of Central and Eastern Europe. Difficult situation in the public finances, but also in the economy, imposes that the number of employees in the public sector must be further reduced, but this reduction should not worsen the quality and the availability of public services which are already low.

The main problem of the public sector in Serbia is its inefficiency, which is only partly the result of excessive employment, while largely the result of poor quality of services that this sector provides. Therefore, in parallel with the reduction in the number of employees by about 10%, the main effort should be directed at improving the quality of work of all parts of the public sector. Reducing the number of employees should not be linear, because while in some institutions there is a surplus of employees, there is a shortage of employees in others. Therefore, in parallel with dismissals the mobility of employees within the public sector should be increased.

average among Central and Eastern Europe countries. In Central and Eastern Europe countries 7.5-8%[3] people is employed in the public sector per 100 residents, without those employed in the state owned enterprises, where the number of employees ranges between 6.2% in Czech Republic and 10.3% in Lithuania. If the number of employees in the public sector would decrease by 15% then the number of employees per 100 residents in Serbia would be 6.2 which combined with the Czech Republic would be the lowest in the Central and Eastern Europe[4].

The question is raised whether the planned reduction of the costs and in the number of employees in the public sector is possible and whether it is desirable? Since the beginning of the crisis none of the Central and Eastern Europe countries has succeeded to reduce the share of the expenditures on public sector employees in GDP by 3.5 percentage points compared to the multi annual average[5]. The largest reduction of the share of these costs in GDP was achieved by Rumania, Hungary, Latvia and Lithuania, but this reduction in 2014 compared to the average from the period 2004-2009 does not exceed 1.7% of GDP. Furthermore, even after the reductions

3 According to Eurostat data in the countries of Central and Eastern Europe in the public sector, without enterprises, 8 workers per 100 residents is employed - although no data are available for all countries. According to other sources the number of employees in the public sector in the countries of Central and Eastern Europe is 7.6 per 100 inhabitants.

4 If it turns out that the number of employees in the sector of general government in Serbia is about 510 thousand then after the reduction of 15% of employees in the public sector in Serbia, in relation to the overall population, would be lower than in the Czech Republic.

5 Latvia, Lithuania and Romania have reduced the share of labor costs in GDP by about 3 pp in 2014 compared to the maximum share in 2008-2009. However, the maximum share is not relevant as a benchmark, because it is the result of a great unexpected fall in GDP in these countries, which is why the participation of all expenditures, and the expenditures for employees in relation to GDP increased. This is not the case in Serbia, because the share of labor costs in GDP in 2014 near the long-term average.

all observed countries have the share of the labour costs in the public sector above 8%.

The planned reduction in the number of employees in the sector of general government by 15% (i.e. 75 000) is significantly based on the natural outflow (retirement, transit to the private sector, etc.) which annually amounts to about 3% or about 15,000. The government plans to apply the rule according to which, on five employees who leave the sector of the general government one new employee is hired, which means that with the natural outflow each year the number of employees will decrease by about 12,000. Applying this rule in industries that employ people with heterogeneous education such as health and education would lead to major problems in the functioning of these activities, even if the mobility of employees in these activities is increased, because it is not possible to substitute a history teacher with a chemistry teacher, or a surgeon with an internist. It is therefore quite certain that the application of this rule cannot achieve the planned reduction in employment, and at the same time not jeopardizing the quality and availability of their services. Therefore, the government will have to rely more on targeted reduction than on the natural outflow.

From the above mentioned, it can be estimated that the planned reduction of the share of labour costs in GDP will be difficult to implement, because none of the neighbouring countries succeed to do that.[6]The realization of the agreed policy would move Serbia from one extreme, in which the share of labour costs for employees in the sector of the general government to GDP was among the highest in comparison to similar countries, to the other extreme where the expenditures on employees in the sector of the general government would be among the lowest. We estimate that the reduction of expenditures on employees in the sector of the general government (health, education, justice, military, police, etc.) for over 2.5 p.p. of GDP (i.e. 2 p.p. by the IMF methodology) would aggravate the functioning of the state institutions. Large reduction of nominal wages would encourage outflow of competent employees (doctors, teachers), reduce the commitment on the job, and encourage corruption. In these circumstances it is not realistic to expect that any reform would lead to the improvement of educational, judicial, security, administrative, or other services provided by the employees of the public sector, which are important for economic development and the development of the society. If the plans to reduce the number of employees in the public sector and to reduce their salaries would be realized, the availability and quality of public services would aggravate, which would adversely affect economic equality. Wealthy citizens would turn to private education, health care, while the poor would be directed to less-quality and less accessible public services.

Therefore, in the course of the arrangement with the IMF it would be desirable to change the objectives related to labour costs, reduction of the number of employees and the indexation of wages in the public sector. We estimate that more adequate objectives would be: share of public sector wages in GDP decreased to around 9% (around 8% according to the IMF definition). This would be achieved by reducing the number of public sector employees by 10% in a three year period, as well as the freezing of salaries in 2015 and 2016, but not in 2017. The labour costs and the number of employees in the public sector would be somewhat below average, while the number of employees would be significantly below the average among the countries of Central and Eastern Europe. Reduced savings on costs of public sector employees would be compensated with a larger reduction of subsidies or improved tax collection. If these measures fail to achieve desired effect, for example if the subsidies cannot be reduced because of the previous commitments, then it will be justified to consider the activation of some of the replacement measures, such as VAT increase. We estimate that from the standpoint of the whole society it is better to increase VAT in a year or two, than to aggravate public sector services due to the lack of commitment of teachers and professors, police officers, or to reduce the availability and quality of health services due to the departure of the best doctors in the private sector or abroad.

The arrangement with the IMF foresees a relatively modest increase of public investments, which is not good from the standpoint of antirecession policy, nor from the standpoint of long-term economic growth. Public investments which were in 2014 at 2.6% of GDP, according to the arrangement with the IMF will be increased to 3% of GDP. Investments of 3% of GDP are low for a country which is building its transport and other infrastructure, which is exactly the case with Serbia. Besides, investments of 3% of GDP are not in line with the concrete Government plans which are, in the next three years, related to the realization of infrastructure projects (road corridors 10 and 11, modernization of railroads, construction of Beograd-Budapest railroad, construction of communal infrastructure, etc.). With investments of 3% of GDP the speed of construction of road and communal infrastructure and the railroad reconstruction would in the following years be similar as in the previous years, which is insufficient.

6 The example of Romania which reduced share of labor costs in GDP for1.7% of GDP, therefore half as Serbia, is very instructive as it has led to a deterioration of public sector services.

Therefore we estimate that it would be desirable to agree the increase of public investments of around 4% of GDP with the IMF. The increase of public investments, which have higher fiscal multiplier than current consumption, could mitigate and shorten the recession period caused by the implementation of fiscal consolidation. Of course, antirecession effects of public investments will be higher if domestic resources (workers, material, etc.) are engaged in their implementation. Increase of public investments that build modern infrastructure would be favourable to the long-term growth of the Serbian economy. Construction of modern highways and railroad lines, which would connect Serbia with the neighbouring countries, modernization of municipal infrastructure, etc., would reduce the costs of doing business in Serbia, which would have a positive effect on the growth of domestic and foreign investment.[7]

7 Positive impact of public investments on suppression of the recession and the long-term economic growth is supported by a number of empirical research.

However, it is justified to ask how would the additional increase of public investments for 1 percentage point of GDP impact the fiscal deficit and the borrowing dynamics of the State? One part of the additional investments (around 0.5% of GDP) could be financed by additional revenues from the suppression of the grey economy. The remaining 0.5% of GDP (around 500 million euros in a three year period) would mean additional deficit increase compared to the actual agreement with the IMF, which could be financed with a part of revenues from the Telekom's privatization – therefore without additional borrowing. Using revenues from Telekom's privatisation for public investments is justified from the economic standpoint because in this way the state assets will remain unchanged, while the wealth of the society would increase.

Highlight 2. Clampdown on shadow economy – first results and further steps

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1. Shadow economy in Serbia – its extent, determinants and measures against it

According to recent empirical studies, the shadow economy in Serbia accounts for 30.1% of GDP, which is by 1/6 larger than in other Central and Eastern European Countries (CEE). Most of these countries have smaller shadow economy, and Bulgaria is the only one with bigger shadow economy than Serbia's (Krstić, et. al. (2013)). At the same time, average size of the shadow economy in EU is 19% of GDP. According to the reasons for the shadow economy (degree of economic development, institutional efficiency, quality of public goods etc.), Serbia is more similar to CEE countries than to the EU average. Therefore, reduction in the shadow economy down to the average in CEE countries would be a realistic goal in the medium term (two to three years). In that case, tax revenues would increase by 1% of GDP. Further actions against the shadow economy with the aim of reducing it to the average in EU countries would push up tax revenues by additional 1% of GDP, which could be achieved in seven to ten years. This means that a clampdown on the shadow economy might help reduce fiscal deficit by 1% of GDP (by 2017), and the remainder of the necessary reduction (by 5% of GDP) would require implementation of some other measures (primarily reduction in current public expenditure).

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Shadow economy comprises all legal economic activities (trade in goods and services, income payments, possession of property etc.) done informally, i.e. off the official records. Tax evasion is the main reason for shadow economy, though there are many others, as well (avoiding the costs of harmonization with other, non-tax regulations etc.). Before deciding whether to engage in the shadow economy/tax evasion, one weighs the potential benefits (tax savings) against the related costs (the amount of the fine weighted by detection probability). Furthermore, some other socio-economic factors, such as the degree of tax morality or the quality of government services, affect the size of the shadow economy. Accordingly, the government could discourage engagement in the shadow economy by reducing the taxes, by raising the fines for tax evasion and by increasing the probability of detecting evadors. Empirical studies show that an efficient government control over tax evasion is the most productive mechanism against it, followed by fine increase, while tax decrease has a limited impact on reduction in tax evasion (observed separately). Given that the tax rates in Serbia equal the European average and are close to the average tax rates in the region, and since Serbia had one of the largest fiscal deficits in Europe in 2014, there is not much room