

HIGHLIGHTS

Highlight 1. First steps and the announced economic measures of the Government

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Elements of the Government's economic program are contained in the expose of the Prime Minister, later statements of the Prime Minister and members of the Government and also in first adopted laws and sub-laws. Announced economic measures can be grouped into four interrelated areas: fiscal consolidation, public sector reform, improving economic environment and antirecession measures. General assessment is that the announced fiscal consolidation is not sufficient and that additional savings measures are needed. Public sector reform, excluding a few exceptions, has not yet been developed and so the evaluation of the Government's plans is not possible. So far, the announced economic reforms are the most ambitious, but these first need to be operationalized through laws and then implemented. When it comes to antirecession measures the authors feel that the announced programs of mass construction of cheap housing and subsidized loans, with certain adjustments, are generally well placed, while the continuation of generous subsidies for employment and investments, as well as tax breaks for new employment, are neither economically efficient nor fiscally sustainable. In order to reverse unfavourable economic trends in public finances and the economy of Serbia it is necessary for the Government to adopt additional measures of fiscal consolidation, realize announced economic reforms and prepare, and then implement the public sector reforms.

Postponement of the IMF visit from June to September indicates that there are still significant differences between the Government and the IMF with regard to economic policy and reforms. Considering the scale of problems Serbia is facing, support for the IMF and other international organizations is necessary to avoid a debt crisis, and there are strong arguments in favour of concluding a stronger arrangement with the IMF.

1. Fiscal consolidation

The Government has planned high fiscal deficit of 7.1% of GDP for 2014, which is the highest planned fiscal deficit in Europe. High fiscal deficit and fast-growing public debt present the biggest macroeconomic risks in Serbia, which directly affect growth of interest rates, net outflow of foreign capital from Serbia and thus also insufficient investments and absence of economic growth.

Already in the period of adoption of the budget it was clear that the fiscal deficit could be somewhat higher because there were strong signals that GDP will stagnate instead of a planned growth of 1%, and it was unlikely that the planned additional revenues from combating the grey economy will be realized in the year when the parliamentary elections are held. Lower inflation than planned and growth of tax debts due to the financial problems in companies influenced the additional fall in revenues and via this the growth of deficit in relation to a plan. Based on the trends from the first four months we have estimated that the fiscal deficit in 2014 will amount to around 8% of GDP. Floods which Serbia faced during the second part of May (more detail on effects of floods in Highlight 2) will have direct effect on the decline in tax revenues of about 0.2% of GDP and will also probably influence a rise in total expenditures, and as a consequence the fiscal deficit in 2014, without additional measures of fiscal consolidation, will be over 8.2%.

The Government's representatives, in the first month, have announced the measures for fiscal deficit reduction, but also measures which will affect its growth. The most important measures for fiscal deficit reduction are the reduction of public sector wages, fight against the grey economy and elimination of unproductive spending. Taken as a whole these measures will contribute to the fiscal deficit reduction in 2014 of 25-30 billion dinars (about 0.7-0.8% of GDP). Reduction of public sector wages by 10% starting from the middle of 2014 for now represents the most important measure of savings, which by the end of the year would bring savings of about 12 billion dinars. However, the net effect of these measures will amount to 7-8 billion dinars due to the fact that simultaneously with the reduction of wages a solidarity tax is being abolished. If in the second half of the year decisive measures are taken to combat the grey economy, the increase in revenues on that basis of about 10 billion dinars can be expected. Due to the extension of the deadline for restructuring of the companies certain savings will be achieved in the retirement benefits, but in this case it is merely a transfer of expenditure from this to the coming year.

In the first few months the Government adopted several measures for elimination of unproductive spending in public sector, such as a reduction in costs for company cars, reduction in official travels and other savings on goods and services. Mentioned savings individually observed have more symbolic significance while their cumulative balance significance is modest. However, it

The impact of timing and delays on the effects of fiscal consolidation

In the expose of the Prime Minister and also later statements from the members of the Government it was announced that the savings measures, but also programs which will as a consequence have additional expenditures (different kinds of subsidies, etc.), will be put into effect by the middle of the year. The estimate of the effects of the fiscal policy was done considering this, still not valid, official announcement. However, in early June unofficial information appeared in the media that the planned savings will be delayed for 2-3 months. If this happens the effects of fiscal policy will be proportionally lower than estimated. Also, it is possible that expenditures, and thus the fiscal deficit would be by 0.2-0.4% of GDP lower than the estimated 8.2% of GDP if the perennial practice of State's delays in the settlement of obligations or their transfer to next year continues.

appears that these savings are not conducted in a systematic way, but are ad hoc measures, which are implemented in the short term with the aim of gaining political points. It is estimated that in the best case savings arising from the abolition of unproductive spending will amount to several billion dinars.

In addition to these savings the Government in the second part of the year plans additional expenditures, such as expenditures for subsidized loans (payment of debts but also new subsidies), expenditures for subsidies for employment and investments and also expenditures for reparation of the damages of flooding. In sum, the above mentioned measures will increase total expenditures by about 15-20 billion, which means that they will neutralize the largest part of the so far planned savings. Thus the net effect of government measures in the second half of the year will be a reduction of the fiscal deficit by only 10-15 billion dinars, which is about 0.3-0.4% of GDP. The aforementioned savings are modest, given the size of the deficit Serbia is facing, as well as the necessity for its fast reduction. Such savings will not bring the trust of investors, regardless that these are structural measures whose effect will be transmitted to the following year. Thus, the fiscal deficit needs the additional savings, which includes all expenses, to decrease by at least 1% of GDP in this year.

Based on the aforementioned we conclude that the so far adopted measures of fiscal consolidation are insufficient. Unless the Government implements additional savings measures, the fiscal deficit in the next few years will remain at a very high level, and public debt will continue with its rapid growth. In such circumstances, the risk of

a public debt crisis will be high. Macroeconomic effects of slow fiscal consolidation will be unfavourable because the insufficient fiscal consolidation would decrease public spending, but that decrease would not be sufficient to gain the trust of private investors and to increase private investments. Decrease of public spending would be followed by a fall in private investments and private consumption through the withdrawal of foreign capital from Serbia and other, which would mean additional fall in GDP and employment. It could be said that this course of events is already happening in Serbia, because the Government in the last two or three years has been already implementing a certain insufficient measures of fiscal consolidation, whit delays and inconsistency in their implementation.

Fiscal consolidation would have a much greater chance of success if at its beginning a strong austerity measures, which would significantly decrease fiscal deficit already in the first year, would be implemented, with simultaneous adoption of measures that will guarantee continuation of the reduction of fiscal deficit in the coming years. In this scenario also GDP would decrease at the beginning of consolidation process, while unemployment would increase because private investors would wait for a while to be convinced in the persistence of government in the implementation of the consolidation. Based on the experiences of a large number of countries it follows that up to two years of consistent consolidation is needed in order to gain the confidence of investors, which is essential for the growth of private investments which should be the main driver of GDP growth and employment in the coming years.

Large savings needed for significant reduction of fiscal deficit are hardly feasible, if already in this year expenditures for pensions are not reduced, either by making the nominal pension reduction or by taxation of the pension amounts above the minimal level. In addition to reducing pensions and salaries considerable potential for savings in the short term is in the reduction of direct and indirect subsidies paid by the State to cover losses and debts of Srbijagas, Železara Smederevo, GSP Beograd, as well as on the basis of subsidizing companies in restructuring process. Also, it is necessary to reconsider the justification for granting generous subsidies for investments and employment, as well as the granting of tax incentives. Systematic and gradual decrease in the number of employees in the public sector and the application of parametric reforms of pension systems can achieve significant savings in the next few years.

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2. Public sector reforms

The objectives of the reform of the public sector are to increase the quality and availability of public services and to eliminate unproductive or fiscally unsustainable spending. Public sector reform should include all functions of the state, but from the point of economic development reforms of the pension system, state and local administration, justice, education and health are especially important.

The government has released the plans for the reform of the pension system, which should take effect in the next year. The most important changes in the pension system are the introduction of actuarial penalties for early retirement in the amount of 4% per year, as well as the increase in retirement age for women from 60 to 63 years. Pension system reforms will contribute to the improvement of its fairness, and in a period of several years they will have a positive impact on the fiscal deficit reduction. However, the pension system reforms will bring significant savings in the long run, so it is necessary to reconsider the one-time reduction of pensions or introduction of taxes on pensions.

Education reforms are crucial for the economic development of Serbia because educated work force could be one of several important comparative advantages of the country. The new Minister of Education in a number of public appearances expressed mainly general and basic views, with some concrete ideas for improving the quality of primary education and some segments of secondary education. Although the effects of changes in the education system are long-term, it is necessary to start with these changes as soon as possible, and it is important that these changes cover all levels of education, from primary to doctoral studies, and that they include both state and private education.

When it comes to primary and secondary education, it is important that the Ministry and the Government propose measures as soon as possible to improve the quality of education, the objectives they want to achieve and the dynamics of their achievement. In addition it is necessary to answer to some key questions within the reform, such as: in which way will the schools be encouraged to educate students for the market demand, when will the rationalization of the school network final begin, whether and when will the secondary education become compulsory, whether and under what circumstances will the state finance the private schools of quality, how to encourage more objective assessment and prevent inflation of excellent students, etc.?

In the case of higher education it is necessary to present a plan to increase the quality of education at state uni-

versities, but also to introduce stricter requirements for accreditation in order to prevent overproduction of poor quality diplomas in primary, master's and doctoral students at private universities. In the case of state universities, the state as the owner could initiate changes that would lead to the situation in which basic and doctoral studies in the course of a decade could catch up with the state universities in small European countries such as Austria, Belgium and the Netherlands¹. Government intervention in the case of private universities is justified because the students and their parents are not sufficiently informed about the quality of educational institutions, and in this case market solutions are not effective, at least in the medium term. An additional problem is that students who complete poor quality universities are massively employed in the public sector, thus reducing the already low quality of state institutions. By hiring graduates of mentioned universities, the State sends a signal to new generations of students that the quality of the university is not important, which is the reason why many students will decide to enrol a less quality but easier universities.

Experience of a large number of countries around the world suggests that the existence of good institutions is crucial for the economic development. Competent, dedicated, uncorrupted and not excessively costly state administration has a key role in making good laws and bylaws and in their consistent implementation. Historically, Serbia has not had much success in the formation of good institutions. Since gaining independence in the second half of the 19th century up until now the state administration was characterized by incompetence, corruption, etc. Creation of good institutions is a necessary condition not only for a long-term sustainable economic development, but also for the stability of a democratic society - poor institutions discredit the democratic system, and citizens often turn to autocracy.²

Although institutions are created gradually it is important the society works on their improvement every year. However, regarding Serbia this is not the case, it could be said that there is a zigzag motion where the periods of improvement and decoration are loosely linked to personal characteristics of relevant ministers and other government officials. Improvement of state institutions requires reduction of the influence of political parties on the work of state bodies, change in the employment and advancement policies in order to stop the negative se-

1 In the previous issue of the Quarterly Monitor prof. Branko Urošević formulated a proposal to elevate doctoral studies at the faculties of economics to the advanced world level with the available modest resources. A similar approach could be applied to other universities in Serbia.

2 In the recent history corruption in Serbia was probably the smallest in the period of socialism.

lection which is in force for many decades, promotion of commitment on the job as one of the core values of the civil servants, introduction of systematic measurement of performance, suppress corruption, etc.

3 Economic reforms

The current economic system represents a fundamental limit to the long term sustainable rapid economic growth in Serbia. It imposes unproductive costs and creates high risks on the economy, which impedes the functioning of the economy and discourages investment and employment. Inadequate economic system is an important cause of poor placement of Serbia on international lists of competitiveness and business conditions (list of the World Economic Forum and the World Bank), which even got worse during the last 2-3 years.

Reforms of the economic system in Serbia were significantly slowed down in 2006th and at the beginning of the economic crisis they were pushed aside. Instead of the economic system reform the Government focused on direct incentives to stimulate investment and employment and solving problems of individual companies. Such policy was completely inadequate since Serbia, unlike other countries, entered the crisis without built system of market economy. Weaknesses of the economic system the Government for several years has been trying to compensate with generous, but economically inefficient and fiscally unsustainable subsidies for investments and employment. The results of such policy were very modest - investments were low, employment is decreasing, while economic activity is mainly stagnant. The lack of reforms combined with the prolonged recession has led to the expansion of illiquidity and insolvency of companies and banks, which were threatening the current functioning of the economy and its growth, and secondarily were transferred onto the government through the cost of rehabilitation of the banking system which has so far reached 800 million euros, or about 2.5% of GDP.

During the second half of the previous year ambitious reforms of the economic system have been announced, including the reform of the Labour law, the Construction Law, the Bankruptcy Law, completion of the restructuring of former public companies and restructuring and partial privatization of public companies. Because of the elections held in March 2014 the announced reforms were left out, but after the formation of the Government it was confirmed that economic reforms are at the top of the list of priorities. Adoption of laws which improve economic environment, as well as concrete moves to restructure public companies and completion of restructuring of former public companies,

along with the willingness to adopt additional measures of fiscal consolidation, will represent a key test of the Government's reform orientation.

In addition to the adoption of laws it is necessary to develop a new credible plan that would guarantee that the restructuring of the former public companies will be completed within a reasonable time, but not later than the middle of the next year. To ensure continuous movement towards this goal it is necessary to accurately determine the quarterly targets which would determine for how much companies the restructuring process will be completed by the end of October, for how much by the end of the year, etc. From the perspective of the fiscal consolidation, it is particularly important that, no later than by the end of the year, the status of Železara Smederevo Steel plant is resolved, because it is a company that is, with Srbijagas, the single largest user of indirect state aid. By the middle of the next year the privatization of all enterprises that are under the jurisdiction of the Privatization Agency should be put to an end.

Public companies in Serbia for a long period of time have created losses, and some of them have had serious problems with liquidity and solvency. Problems from public enterprises are transferred on the State, which covers part of their losses and repays part of their loans, and on the private companies to which public companies owe. From the standpoint of the budget, priority is the restructuring of the companies which lead to the growth of government expenditure, and here from the standpoint of balance significance the most important company is Srbijagas, followed by Serbian Railways and GSP Belgrade. Also, there are indications that the financial position of EPS is rapidly deteriorating. It is therefore important that the Government gets out as soon as possible with a plan to restructure the public companies, whereby the priority would be on aforementioned companies that bring the highest cost to the environment.

The Government has announced its readiness to privatize some public companies and financial institutions owned by the state, which among other things raises the question how will the revenues from privatization be used? In the period from 2006 to 2008 the state used revenues from privatizations to, in the long term unsustainably, raise pensions and salaries in the public sector, launch a massive program of subsidies and reduce taxes. Irresponsible decisions made at that time created the largest part of the fiscal imbalance Serbia is now facing.

In the current circumstances, it is unlikely that the government will use the revenues from privatization to increase public expenditures and fiscal deficit, but there is a risk that the revenues from privatization are used

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for disposal and mitigation of fiscal consolidation. Such behaviour of the Government would be myopic and irresponsible, because the problems in public finance would pile up further. It is therefore important that by the middle of this year decisions are made that would ensure that the fiscal deficit is significantly reduced in this and the next few years, regardless of whether the state will earn revenues from privatization or not. If the state strongly decreases fiscal deficit then it would be justified for privatization revenues to be used for its financing because the asset position of the state would not deteriorate –how much the state assets decrease, due to the privatization, that much its debt would be reduced. When evaluating the feasibility of use of privatization revenues to finance the fiscal deficit it is necessary to bear in mind that the average interest rate at which the government borrows are higher than the profit rates that public companies achieve over a longer period.

4. Antirecession measures

Strong drop of investments, a real decline in the volume of lending activity, decline in employment, stagnation of the overall economy followed by a recession in many sectors justify the use of antirecession measures in Serbia. Given that the typical stimulants which are used in large developing countries, such as lowering the interest rates of the Central Bank or fiscal stimulus, in Serbia as a small and open euroized economy, are not effective, it is necessary to use atypical stimulants. The need for government stimulants is further reinforced by recent floods, which have caused a relatively large damage to public and private property. It is therefore necessary to integrate the measures for the flood damage restoration with antirecession measures. Although economic incentives are justified it is necessary to bear in mind that these are temporary measures with limited range, which are intended to mitigate the recession, but that the long-term prospect of Serbian economy depends on economic reforms. Therefore the temptation to push economic reforms aside again due to the antirecession measures and measures for the flood damage restoration should be avoided.

Until now the Government has announced three key antirecession measures, and these are tax and direct budget subsidies for employment and investment, subsidies for lending and mass construction of cheap apartments. State investments, in-kind subsidies and subsidized loans for flood damage restoration could be added to these measures.

The most controversial of these measures are high tax subsidies for new employment, as well as the generous budget subsidies for investments in jobs. Tax subsidies

for new employment in Serbia have been applied since 2011, but their effect was more than modest. This type of subsidies was popular around the world, but it proved to be ineffective. Additional problems with the use of these tax incentives are that they create distortions in the tax burden of jobs that create identical incomes, and that they open room for various types of legal tax avoidance and fraud.

Granting generous budget subsidies for investment and employment represents a return to the policy of subsidizing that was implemented until the middle of the last year, with the only difference being that now granting subsidies is limited to two years. These types of subsidies attracted a number of investors in the past, as was very strongly promoted by the media, but the results of these policies at the macro level were weak because total employment and investment declined. Investors who receive budget funds, beside those, use generous tax incentives, such as multi-year exemption from corporate income tax and exemption from some local duties³, as well as in-kind subsidies in the form of free land. Granting of such subsidies at the macro level is probably counterproductive, because in this way the fiscal deficit increases, and so do the macroeconomic risks, and attracting of several investors with fiscally unsustainable subsidies discourages large number of other investors from investing in Serbia.

Therefore, the policy of encouraging investments should primarily be based on improving the economic environment, while subsidies should be limited to in-kind subsidies and tax incentives. Generous subsidies like arranging of locations and similar would only be granted in the case of large value investments.

Given that the lending activity for more than two years has had a large real decline, granting subsidies for loans represents extorted but reasonable measure. The application of this measure with relatively small government funds (several billion dinars) encourages crediting of about 100 billion dinars. For companies that are in financial problems, state subsidies increase the willingness of banks to offer them once again refinancing of old, hard performing loans. However, in this case, subsidized loans only “buy time”, but the big problems these companies face are not being solved. It is therefore essential that the owners of these companies are further “pressed” to take serious steps to solve the problems they face, such as selling part of the company, recapitalization, etc. - if the owners are not willing to take such steps then the bankruptcy is the only solution. Given that a large part of the subsidized loans in the past was approved precisely to these companies, and

³ In several cases investors were even freed from contributions on salaries.

that in the meantime they did not take any steps to solve the essential problems, it is estimated that it is necessary to reduce the amount of subsidies that are approved for refinancing of old loans and thus further boost pressures on the owners of these companies.

Limiting the percentage of subsidies intended for refinancing of old loans would create space for the increased availability of loans for healthy, especially small and medium enterprises, where high interest rates are the main obstacle for the use of bank loans. With subsidies that reduce interest rates bank loans would become cost-effective for a wider range of companies. In this case also, subsidies are only a temporary measure, and it is essential to eliminate systemic causes of high interest rates in Serbia.

Finally a part of subsidized loans could be focused on the households, entrepreneurs and companies who have suffered from flood damage. In the case of households subsidized loans would be approved for the rehabilitation of damaged houses, purchase of furniture and household appliances and repairs on agricultural mechanization. In the case of entrepreneurs and companies subsidized loans would be used for the rehabilitation of damaged business premises, renewal in inventories, etc. Loans to entrepreneurs who have suffered damage would contribute to the renewal of economic activity and employment in the shortest period possible.

Important antirecession measure announced by the government is the mass construction of cheap apartments. Realization of this program is economically and socially justified because it will enable productive employment of several thousands of workers, and also it will provide the opportunity for several thousands of households to solve their residential issue. Mass construction of apartments with the implementation of at least some of the announced investment programs, and recovery from floods, would help the recovery of the construction industry, which is in a deep recession.

Details of the program of mass construction of apartments contained in the speech of the Prime Minister and later statements by the representatives of the Go-

vernment largely coincide with the proposals outlined in the last issue of QM⁴, but there are some differences. In both proposals, cities and municipalities would provide free construction land, which would significantly affect the reduction in final apartment prices. The difference between the two proposals is that according to our proposal future buyers would bear the minimum costs of construction land, while according to the proposal of the Government those costs would be borne by the local communities. As a result, the final price of apartments according to the proposal of the Government would be about 400 euros, while according to our proposal about 500-600 euros, and in Belgrade perhaps slightly more.

We still think that the free allocation of construction land is sufficient and large subsidy for future buyers of apartments, and that it is not justified for the costs of construction land to be transferred to local governments, i.e. all citizens. Here we remind that the ultimate cost of any subsidy is borne by the citizens, and that the state is only an intermediary in that process. In this particular case, this means that according to the proposal of the Government all people, including the poorest, as well as those who for decades have been saving to buy apartment at a price of 1000 or 1500 euros for m², would subsidize one part of citizens to buy apartments at a price of 400 euros. There should also be some limits in the case of these subsidies, according to our assessment this means that future buyers should pay the costs of the construction of apartments as well as the minimum cost of construction land. In this case, monthly rate for repayment of the loan would amount to just over 200 euros, which is bearable for a family with the average income. This rate implies much less waiver from that borne by the majority of families who over the past 15 years purchased apartments at market prices. Given that the mass construction of apartments contains a considerable amount of subsidies, it is necessary to give priority to the purchase of apartments to families with unsolved housing issue.

⁴ See p. 66-67 in QM35