HIGHLIGHTS

Highlight 1. Analysis and Evaluation of the Fiscal Policy for 2014-2016

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In this Highlight we will give a general evaluation of the adopted fiscal policy, analyze individual measures and challenge some of the alternative measures.

General remarks

The adopted fiscal policy for 2014-2016 does not attack the problems in Serbian public finances and economy adequately. The greatest weakness of this policy lies in the projected increase in fiscal deficit from already high 6.6% of GDP in 2013 to 7.1% of GDP in 2014. Increase in fiscal deficit in the first year of the announced shift in fiscal policy, and strong fiscal adjustments not before 2016 undermine the credibility of this policy. Credible fiscal policy is important to Serbia in many ways. Credible fiscal policy, positively evaluated by IMF, would reduce costs of borrowing, and more importantly, alongside other policies and reforms it could reverse the downward trends in private investments and private consumption.

We therefore think that additional savings of about 1% of GDP need to be made in the next year to make at least a symbolic reduction in fiscal deficit in 2014 relative to this year. To produce effects on economy already in 2014, the austerity measures should be adopted as soon as possible, and side by side with short-term savings, a plan for reforms in public sector that would guarantee reduction in fiscal deficit in the years to come need to be implemented. This implies that the government must adopt a sweeping pension reform, plans for right-sizing the number of employees in the public sector, restructuring plan for Srbijagas and other public enterprises, effective measures against shadow economy, etc. To give credibility to the reform plans, the Government must fully implement the measures that have been adopted so far, such as the plan for settling the status of companies undergoing restructuring.

Reduction in fiscal deficit to 6.1-6.3% in the next year would make fiscal consolidation plans for 2015-2016 feasible. However, with fiscal deficit at 7.1% of GDP in 2014, it would be quite unlikely to reduce fiscal deficit to 5.2% of GDP in 2015 and to 3.2% of GDP in 2016. If fiscal deficit narrowed to somewhat above 6% of GDP in 2014, and remained within the levels projected in the fiscal strategy in 2015 and 2016, fiscal consolidation in Serbia would still be moderate, and not too sharp. From the aspect of economic recovery we think that a gradual fiscal consolidation would be more suitable for Serbia, because Serbian economy is facing a sharp reduction in credit activity.

In edition to fiscal consolidation and reforms, it is necessary to take measures for improving extremely poor liquidity of economy, through joint action of fiscal and monetary policy. Liquidity-focused measures would help solvent companies faced with temporary financial problems overcome the crisis, and efficient bankruptcy procedure would enable elimination of insolvent companies from the market. Of course, recovery in a small open economy like Serbia's largely depends on the developments in the region, and in the case of Serbia on economic trends in EU.

Additional savings, which would reduce fiscal deficit in 2014 and in the following years, are necessary, not only from the aspect of public finance, but also from the aspect of economic recovery. Because investors are aware of the possibility of public debt crisis in Serbia, rise in domestic demand through rise in fiscal deficit is canceled out by fall in investments and private consumption. Consequently, GDP growth rate will stand at only 2% in 2013 in spite of very strong fiscal stimuli manifested through fiscal deficit at 6.6% of GDP. Economic growth of 2% in 2013 did not come from large fiscal deficit, or high domestic demand, but from the factors on the supply side – increase in agricultural production, and in FIAT and NIS production. Serbian economy is expected to stagnate in the next year, although fiscal deficit will run at as much as 7.1% of GDP. Even when domestic demand was by 20-25% higher than GDP, there was no significant growth in Serbian economy, which is understandable since this is a small open economy. In the period 2001-2012 Serbia was among Central and Eastern European states (CEE) with the largest surplus of domestic demand relative to GDP, but its economic growth was below the average in CEE states. This proves conclusively that increase in fiscal deficit does not lead to growth in GDP, but it reduces it, under the existing circumstances. Fiscal multipliers in a small open economy with flexible exchange rate are low in general, but under large indebtedness they become negative. Negative fiscal multipliers are detected in countries with large public debt and low credit rating, which is the case of Serbia.

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Fiscal stimuli in Serbia are inefficient also because the main obstacles to economic growth are on the supply side, and not on the demand side. Main obstacles to economic growth are on the supply side, i.e. in the weaknesses of economic system which discourage investment and entrepreneurship, such as lax financial discipline, administrative barriers, inefficient judiciary, poor infrastructure, rigid labor market etc. Domestic demand in Serbia, although declining steeply, is still much higher than GDP, but it does not stimulate economic growth.

Although a strong fiscal consolidation which would lead to reduction in fiscal deficit in 2014 was announced after reshuffling of the government, it was not carried out. Some of the announced measures have been eased considerably (savings on salaries), some have been put off (pension reform, Srbijagas, Železara Smederevo), and some additional expenditures were financed hastily (public broadcasting service funding). Additional expenditures related to settling the status of the companies undergoing restructuring (transition fund) are justified, because they are intended to solve some of the greatest structural problems in Serbian economy. From the aspect of fiscal economy, it is good that these are one-time expenditures that will not cause a permanent increase in fiscal deficit. However, we believe that additional spending does not justify increase in overall fiscal deficit.

We believe that fiscal consolidation failed to meet the announcements primarily due to the structure of the government. The current government, similar to the previous ones, consists of many parties, so probability of early elections is increased, and they are constantly in election campaign mode. Consequently, ruling parties tend to shift the responsibility for unpopular measures to their coalition partners, so some key decisions are not being made, some are deferred, and the decisions that have been reached are suboptimal. Inefficient decision making process in the Government (consensus) is an especially big obstacle in the period of economic crisis when responses have to be quick, and many, often unpopular, measures have to be made. In broad coalition governments, such has been Serbian for the past 13 years, small parties are in good position because they have large influence on decision making process, but take only a small share of responsibility for overall performance of the Government.

Analysis of individual measures of fiscal policy

Regarding the structure of fiscal consolidation measures, approximately one half of these measures will be taken on the revenue side of the budget (increase in the lower VAT rate, abolition of investment tax credit, shadow economy curbing), and the other half of the measures will be implemented on expenditure side of the budget (reduction in wages in public sector, reduction in subsidies, reduction in expenditures on interest payments). Although this fiscal consolidation program has a more adequate structure than the one from 2012, which mostly relied upon increase in revenues, in a comprehensive fiscal consolidation program fiscal consolidation must primarily be achieved through reduction in public expenditures.

Comparative analyses show that the tax burden in Serbia is not small (as GDP %), and equals the average in CEE states, and that public expenditures (as GDP %) are above the average in CEE states. This suggests that the large fiscal deficit in Serbia does not come from low taxes but from high public expenditures, meaning that reduction in fiscal deficit should be driven primarily by reduction in public expenditures. By economic classification, expenditures on wages in public sector and pensions, and expenditures on subsidies are well above the average in CEE states, while other expenditures (on goods and services, social security, interest payments etc.) equal the average in CEE states or are below it (public investments). Although the foregoing measures are expected to bring savings of 1.2-1.5% of GDP in 2014, the final effects of many of these measures are uncertain (shadow economy curbing or reduction in expenditures on interest payments, and to a smaller extent, reduction in expenditures on subsidies). It is therefore necessary to prepare additional measures that would be taken if some of the implemented measures failed to produce the desired effects.

Regarding the measures on the revenue side of the budget, we think that the increase in the lower VAT rate from 8% to 10% is inevitable, and the key advantage of this measure is that it will produce effects in short-term, and there is no sound reason to expect that it will reduce domestic demand and GDP. Arguments against increasing VAT, often heard in the public, are based on the claim that the increase in VAT rate from 18% to 20% in 2012 led to the drop in demand, and that something similar can be expected now. We find such claims economically unfounded, because the data show that the drop in domestic demand is steep and driven primarily by decreased willingness of foreign investors and creditors, and domestic banks to fund private investments and private consumption. If VAT rate had not been increased, fiscal deficit would be even larger, and this would lead to further decrease in investments and private consumption. If the drop in demand was attributed to the rise in prices driven by VAT rate increase by 2 percentage points, price elasticity of demand in Serbia would prove much higher than in other countries, but there is no plausible explanation for this.

One of the measures on the revenue side of the budget is abolition of corporate income tax relieves (investment tax credit). Under a moderate tax rate (corporate income tax rate in Serbia at 15% is still below the average in CEE states – 15.2%) tax relieves do not encourage investments, but increase tax expenditures, which total RSD 22 billion per year in Serbia. Accordingly, abolition of this tax relief is economically justified and in line with the best tax practices, both in developed and developing countries. However, abolition of this tax relief only few months before the beginning of the taxation period lowers the predictability of business environment in Serbia. The government therefore must make a strong commitment to announce important changes to tax system in advance and introduce them gradually afterwards and thus leave the companies room to adjust.

Fiscal consolidation program also includes measures for curbing shadow economy, which are expected to bring in revenues of 0.25% of GDP, and additional 0.1-0.15% of GDP from the reduction in illicit sale of excise goods in 2014. Shadow economy down by 0.3% of GDP annually can be achieved if the government starts a full implementation of a wide range of measures as of the beginning of 2014. Any reduction above this is considered unrealistic. However, since it takes considerable time to implement some of these measures (the Tax Administration reform, intended to increase the level of inspection activities), and because there is no consensus about some of them (ban on sale of new industrial products at green or flea markets), it is uncertain whether they will bring in the projected revenues in 2014. Since the battle against shadow economy is expected to bring a considerable increase in public revenues in 2014, intermediate goals, i.e. amount of revenues to be collected by the Tax Administration by the end of each quarter in 2014, should be set, so that the level of accomplishment of that goal can be used as an important measure of performance of the Tax Administration employees and management.

Solidarity tax, i.e. reduction in net earnings in public sector, is the key fiscal consolidation measure on the expenditure side of the budget proposed by the Government. Since massive expenditures on employees make a large share of Serbia's huge fiscal deficit, we find the decision to reduce expenditures through reduction in these expenses good. High expenditures on employees in the public sector come from an excessive number of employees (the number of employees in the public sector in Serbia is by 15% larger than needed), and quite high wages relative to GDP and relative to the wages in the private sector. Accordingly, we find the announced reduction in wages in the public sector necessary, but the plan for its implementation is wholly inappropriate. Firstly, this measure should be imposed on employees earning a middle level of wages (about RSD 40,000 per month) as well, because these employees are believed to be the least productive (administrative personnel etc.).

Additionally, expenditures on pensions make a larger share of the fiscal deficit than expenditures on wages, so it would be justified to impose this measure on pensions as well, all the more because the current amount of pensions came from extraordinary discretionary increases in 2008, which are not related to the years of service and similar. Extended scope of this measure, implying reduction in wages and pensions above RSD 40,000, would provide for equal fiscal effect (0.3% of GDP) through a lower rate (7-8%). Alternatively, it would be justified to include all wages in the public sector above the minimum (about RSD 23,000 per month), and all pensions above the average (RSD 23,000 per month) into the scope of this measure - 3-4% reduction in these items would provide for equal budget impact.

Box 1. Why is the adopted "solidarity tax" model inappropriate?

In economic literature, the idea that taxation of broad base at low rate is more efficient than taxation of narrow base at high rate won recognition, because in the second case taxes are less distortive. Accordingly, the adopted plan which envisages reduction only in wages and other earnings above RSD 60,000 by as much as 20%, or 25% (for earnings above RSD 100,000), will impair the efficiency of the public sector, and produce limited fiscal effects (fiscal deficit narrows by 1/20%). Because originally the scope of this measure was limited, in its final draft it has been expanded, which will impair the efficiency in some segments of the public sector. This solidarity tax will be imposed on all monthly earnings (not only wages) of the public sector employees above RSD 60,000, which is quite discriminatory towards those public institutions which have to compete against private companies to earn a part of their revenues – for example, author's royalties from books published by the Official Gazette of the Republic of Serbia will be by 20-25% lower than the royalties from the same book published by a private publishing house. These institutions, which are up against a severe market competition, are thus being discriminated and punished for their competitiveness. Consequently, a part of their business operations will be transferred to the private sector (for example, private companies will be founded to compete for research and development projects, author's royalties will be transferred to private publishing houses etc.), which will impair the performance and efficiency of these public institutions. Additionally, equal treatment is given to public institutions competing in the market (for example, hospitals which are bidding for international research and development projects) and the public institutions which have been granted a monopoly (public agencies etc.). We also think that the proposal by which control of solidarity tax collection is put under the authority of the Tax Administration is inadequate, because, this body is unable to collect the existing taxes efficiently with its present capacities, and downward trends in public revenues and in VAT collection confirm this (the Fiscal Council, 2013). If solidarity tax collection is put under the authority of the Tax Administration, with its present capacities, it will lack the resources to control private taxpayers. Consequently, this could boost shadow economy. We believe that the solution to the problem of quite high wages in the public sector (relative to the private sector) lies in a comprehensive reform in the wage system, through which all persons doing the same or similar job in any part of the public sector would earn approximately equal wage. However, reduction in public expenditures through this measure implies that it should on average bring the reduction in the sum of earnings in the public sector. Additionally, a limit should be put on earnings in public agencies, which are partly funded from their own revenues earned on the basis of a law-granted monopoly.

In addition to solidarity tax, it was proposed to stop filling vacancies (arising from retirements, resignations etc.) temporarily, by the end of 2015. Estimates show that approximately 5-6% of the public sector employees will go into retirement in the following two years. Some of these vacancies will have to be filled, but if a half of them remain unfilled, the number of employees will decline considerably, by about 10,000 in a two-year period. Although the number of surplus employees varies, estimates show that there are more than 5% surplus employees in most public institutions. This temporary measure is therefore justified and good.

Employment freeze is a suboptimal temporary measure, which should be applied until accurate estimates of the surplus employees in all parts of public sector (administration, education, health care system, culture etc.) are made, and on the basis of them, employee right-sizing plan, through which the number of public sector employees in Serbia (per 1,000 citizens) would approximate the average in CEE states by the end of 2016, is formulated.

Additional reduction in wage and pension indexation in 2015 and 2016 (by 0.5% in April and October both years) is envisaged in the draft amendment to the Law on Budget System. This measure is considered necessary. However, reduction in the relative amount of public expenditures and fiscal deficit through this measure will largely depend on the trends in inflation. Under a considerable slowdown in inflation, this measure would produce less marked effects on fiscal consolidation than planned. In that case, measures implying complete freeze on wages and pensions or their nominal reduction would have to be considered.

Reduction in expenditures on subsidies of about 0.3% of GDP is planned in this package of measures, which is considered necessary because expenditures on direct and indirect subsidies in Serbia are among the highest in Europe. However, there is a risk that these savings could be smaller, i.e. that the fiscal deficit could widened if the local governments do not reduce subsidies to local public utility companies. It is therefore necessary to reduce subsidies to public utility companies both on the local and the central government level and establish an appropriate institutional framework for their self-sustainable operating.

The announced considerable reduction in subsidies on investments and employment is conceptually correct, because these subsidies are a price the government has been paying for an uncertain business environment. However, complete abolition of subsidies before the key reforms in business environment have been carried out (Labor Law, Planning and Construction Law, Bankruptcy Law etc.) could lead to drop in investments. We therefore believe that a gradual reduction in subsidies, side by side with the reforms in business environment would be a good solution. In some subsidy schemes (Railways, agriculture etc.) subsidy granting mechanisms should be changed, to improve their efficiency.

In spite of the reduction in the direct subsidies, total expenditures on subsidies remain high, due to extremely large indirect subsidies (in domestic methodology they are recognized as below the line transactions, whereas in international methodology they are recognized as expenditures on subsidies). These are primarily budget payments for government-guaranteed loans to public and state-owned companies, and for financial rehabilitation of banks. Under the line expenditures, on liabilities that have been taken on previously, will amount to 1.7% of GDP (approximately EUR 500 million) in 2014, which is by 0.8% of GDP (EUR 240 million) higher than in 2013. This is one of the chief reasons why the fiscal deficit will widen in 2014 relative to 2013 in spite of the fiscal consolidation measures. Possible government intervention in some of state-owned banks, which are facing serious problems, could increase these expenditures above the targeted. Without a considerable reduction in these expenditures, all other fiscal consolidation measures will fail to produce a marked reduction in fiscal deficit.

In 2014-2016 Fiscal Strategy it has been recognized how important it is to stop the rise in state-guaranteed debt and it has been announced that the restructuring of public companies, as the largest state-guaranteed loan borrowers, will be finished by mid 2014. The Law on the Budget of the Republic of Serbia for 2014 also envisages issuance of government-guarantees on loans necessary to finance semiannual liabilities of these borrowers. Restructuring of these public companies (primarily Srbijagas) is a quite complex and time-consuming process. However, mid 2014 is considered the deadline for restructuring, otherwise sustainability of the public debt would be jeopardized in spite of the proposed fiscal consolidation measures. If the process of Srbijagas restructuring missed the deadline, increase in public debt in 2014 based on the issued government guarantees could cancel out the effects of the adopted fiscal consolidation measures. Additionally, state-owned bank management should be improved considerably, as well as private bank supervision system, to reduce fiscal risks based on government interventions in the banking sector.

The announced measures for fiscal consolidation will affect the local government level as well, primarily by directing local governments (through system of transfers) to reduce subsidies, and through reforms in the system of wages and employment. Additionally, transfers to local governments could be partly conditioned by the degree of exploitation of the property tax revenue impact, which is considered a good measure. However, frequent *ad hock* reforms have impaired the equity, efficiency and transparency of the system of transfers to local governments in Serbia compared with the period after the Law on Local Self-government Funding came into force in 2007. We therefore believe that the reform in the system of transfers to local governments in Serbia is necessary. The system could be designed on the basis of the system of transfers from 2007, which would be adapted to the changes that have occurred in the public finance in Serbia and the fact that local governments have to rely largely on financing from direct and transferred public revenues. Drop in credit activities of banks, rise in bad debt, and extremely poor liquidity of economy dramatically impair economic recovery in Serbia. Use of limited and focused incentives to credit activity is justified and needed to prevent a drop in GDP during the process of fiscal consolidation. In the previous years, the Government of the Republic of Serbia paid subsidies on loans to reduce expenditures on interest payments and boost credit activity. This measure proved quite efficient because subsidies of RSD 4-5 billion lead to RSD 80 billion of granted loans. The Government decided to replace the program of subsidized loans with the program of government guarantees on bank loans, and appropriated RSD 12 billion for this purpose. We think that these measures are a step back, from the aspect of both credit activity impact and public expenditures. Government guarantees on loans cause moral hazard, which means that the banks will demand government guarantees on loans with above-average risk. Another problem is that the Guarantee Fund assets are not recognized as budget expenditures, meaning that real expenditures, and consequently the deficit, will be larger than projected by the amount of the repayment of the guaranteed debt.

Evaluation of some alternative measures for fiscal consolidation

Statements that the government should not make savings on wages and pensions or increase taxes, but that they should increase fiscal deficit to stimulate economy, could be heard in the public when the fiscal consolidation program was presented. We find such proposals utterly inappropriate and populist. These measures may be politically lucrative but they would lead to even larger drop in investments, economic activity, and to public debt crisis.

Additionally, reduction in expenditures on interest payments through reduction in public debt, revenues from privatization and replacement of expensive credits with the cheap ones, are proposed as an alternative to savings on wages, pensions and subsidies and the tax increase. The data clearly show that savings from refinancing expensive loans by cheaper ones can bring only 5% reduction in fiscal deficit (in the following two years). We therefore find the statements that the budget can be balanced primarily by refinancing the expensive credits with the cheaper ones, rather than through reduction in other current expenditures (wages, pensions etc.), unfounded. Such analyses and claims impede the process of the public finance consolidation, because they are confusing to the public regarding the need for savings on wages, pensions, subsidies etc. As we wrote in the previous issue of the Quarterly Monitor, and the conditions under which the new issuance of euro-denominated bonds of the Republic of Serbia was done confirm this, refinancing of expensive credits by the cheaper ones under the market conditions is not possible, but it can possibly be achieved through an inflow of considerable revenues from privatization or bilateral arrangements. Accordingly, possible arrangement of a cheaper loan with the UAE and/or considerable inflow of revenues from privatization totaling USD 2-3 billion would be positive, but it is still uncertain. These funds, if received, should be used to refinance the expensive credits or to cover the current fiscal deficit, depending on the difference between the current interest rates and the highest interest rates under which the earlier loans were granted.

Claims that electronic control of fiscal receipt issuing will bring in additional tax revenues of highly unrealistic EUR 1 billion lead to confusion as to whether the savings proposed in the fiscal consolidation program are necessary. Such statements made by government representatives cause confusion not only among the decision makers but also among the public. Although the representatives of the Tax Administration probably have no intention of causing confusion, by these hasty statements they send a message that the proposed savings on wages, pensions and subsidies etc. are not necessary, because simply introduction of modern fiscal cash registers can bring EUR 1 billion increase in tax revenues.

Literature:

– European Economic Forecast, Autumn 2013 (2013), European Commission, Brussels

– Fiscal Strategy for 2014 with the projections for 2015 and 2016, Ministry of Finance of the Republic of Serbia, Belgrade, 2013

– Evaluation of the Fiscal Strategy 2014-2016 and draft 2014 Budget, Fiscal Council, Belgrade, 2013

Highlight 2. Low Inflow of Foreign Direct Investment: Regional Problem or a Specificity of Serbia?

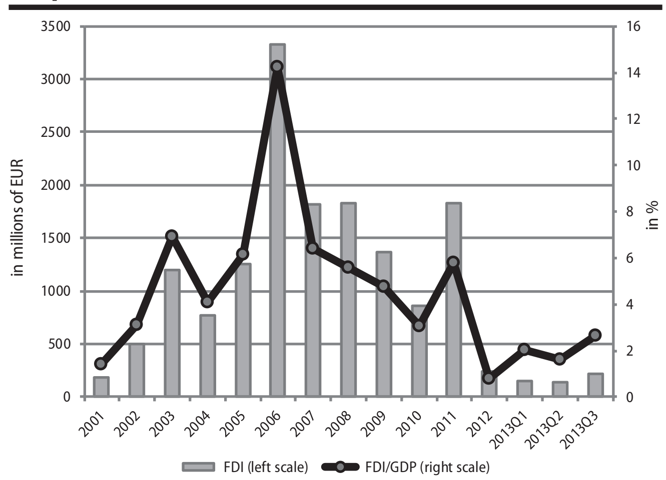
Mirjana Gligorić [1]

This paper is going to compare the trends of foreign direct investment (FDI) in Serbia and the countries of Central and Eastern Europe (CEE) in the period 2001-2012. Even though the analysis covers the entire stated period, the focus of the analysis will be the trends of FDI during the crisis period and especially in the last two years. The latest period is especially analysed from the standpoint of the impact of subsidies on the FDI inflow.

During 2012 and in the first nine months of 2013, inflow of FDI in Serbia have significantly declined compared to the previous inflow levels, especially in the period before the crisis. That is why the focus of this paper is to examine to what extent this phenomenon is specific to Serbia and to what extent it is characteristic of countries in the region and CEE. Graph 1 shows that FDI in Serbia have recorded significant amounts since 2001 (in 2006 they reached 14.4% of GDP). Also, the Graph shows that the FDI inflows have had a downward trend since the beginning of the global crisis, as well as that this trend was stopped in 2011, which means that even after the crisis, although reduced, the average FDI were for the most part kept at a solid level until the end of 2011 (average value of FDI inflow from 2009 to 2011 was 4.5% of GDP).

However, the extremely low inflow of FDI in Serbia since 2012 indicates a potential problem for the local economy from the standpoint of covering the current deficit, as well as considering the impact of FDI on the economic growth. Therefore, the question is whether the current poor inflow of FDI will continue in the coming period as well, which would be especially disconcerting having in mind both perspectives mentioned (balance of payments equilibrium and economic growth), what led to this (general factors or specific characteristics of Serbia and problems that the local economy is currently facing), and what are the possible solutions?

Graph 1. Serbia: Net FDI Inflow, 2001- Q3 2013



Source: NBS, *QM*.

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