HIGHLIGHTS

Highlight 1. Fiscal consolidation – alternatives and consequences

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Based on the trend in the last seven months it is estimated that Serbia's fiscal deficit in this year will amount to about 8% of GDP, which will be the largest deficit in Europe as well as the largest deficit Serbia recorded since 2000. As a result of this deficit public debt is going to rise in this year for about 2.5 billion euros, and will reach 70% of GDP by the end of the year. In this year the state will spend around one billion euros on credit interest, which is more than the expenditure for the army or the police, and as half of the total healthcare expenditures. If the fiscal deficit is not reduced public debt will reach close to 80% in 2015, and credit interest will be 1.15 billion euros.

Despite extremely worrisome trends in the movement of the fiscal deficit and public debt, the public still debates whether it is necessary to take measures of savings. There are opinions that the problem of fiscal deficit can be solved with the economic growth. Representatives of such views argue that the growth of the economy would increase employment and consumption, which would automatically increase tax revenues, thus with keeping public spending at the current level the fiscal deficit would be reduced. According to even more extreme standpoint, not only that Serbia should not reduce consumption, but it should even increase it considering that the economy is still in recession. Increased government spending, according to these proposals, would launch the economic growth, which would then solve the problem of the fiscal deficit. Representatives of this viewpoint often adduce to the fiscal policies of large developed countries, like the United States, and the statements by economists like Krugman and Stiglitz. Also, it is occasionally argued that Serbia's public debt of 70% of GDP is not a big problem, because most EU member states have debt which is greater than 80% of GDP. From the abovementioned it is concluded that due to the fact that public debt is not a big problem sharp fiscal consolidation is not necessary. We will try to challenge previous stances below.

1. Why is the fiscal deficit reduction necessary?

Statement that the problem of high fiscal deficit and public debt can be solved with the GDP growth can be challenged with the fact that this did not happen in some other countries and so chances for this to happen in Serbia are low. Other countries implemented harsh austerity measures and increased taxes[1] instead of waiting for GDP growth to solve the problem of fiscal deficit. The reason that the problem of a high fiscal deficit cannot be solved with GDP growth is that high fiscal deficits negatively impact the economy in many ways.

Reduction of a high fiscal deficit is necessary in order to reduce high macroeconomic risks, and this is one of the prerequisites for starting up the economic growth. To what extent macroeconomic risks have become serious constraint to the growth of the economy is indicated by the ranking list of the World Economic Forum for 2013-2014, according to which Serbia is on a 136th place ranked by the macroeconomic environment, which is far below the overall ranking of Serbia's competitiveness (101th place). Of course, fiscal consolidation is not sufficient to trigger Serbia's economic growth, but if not implemented it is almost certain that there will be no growth. In addition to fiscal consolidation, a number of reforms are necessary for the growth of the economy, such as the improvement of the economic environment, public sector reform, and in the period of crisis some fiscal and monetary stimulus are justified.

Proposition that Serbia, in times of recession, should increase consumption in order to start the economy would mean that, in addition to all existing taxes, the state should further increase the fiscal deficit. In doing so, representatives of such proposals neglect that Serbia de-facto has been conducting such policy since 2011 – public consumption and fiscal deficit were raised faster than taxes, but the result of such policy was not growth of the economic activity, but its fall. Even in this year, in which Serbia has a largest fiscal deficit in Europe, the economy would, without floods, in best case be stagnant, while its decline would be more likely (see section on economic activity). Problems of Serbian economy which limit its growth are not primarily on the demand side as domestic demand continues to exceed supply. Representatives of such proposals manipulate the statements of leading world economists like Krugman and Stiglitz which refer to big countries (USA, Germany, and China) whose economies have significantly different characteristics from Serbian, while their fiscal position is much more favorable. Moreover, the explicitly Krugman's statement which he gave during his visit to Serbia is ignored, according to which his advices proposed for the USA, Germany and others do not apply for Serbia as a small and open economy.

1 We wrote about this in more detail in QM35

Justification of implementation of the savings measures is challenged with statements that with savings the fiscal deficit cannot be reduced, not just as a percentage of GDP, but even nominally?! According to this opinion savings reduce domestic demand, and this leads to a higher fall in public revenues than a reduction in spending, and so the deficit rises. Though this kind of a development is generally (ie. mathematically) possible, it is highly unlikely, and it is even less likely to be lasting.[2] Savings can affect the growth of the fiscal deficit as a percentage of GDP when private investors do not believe in the persistence of the Government in the implementation of the austerity measures, and therefore parallel with the state savings private investments decline. However, if the Government is consistent in the implementation of fiscal consolidation measures, investors' confidence will be received, even if it did not exist at the beginning of the program implementation.

The argument that the level of a public debt of 70% of GDP is not alarming in case of Serbia, because the majority of EU member states have public debt which exceeds 80% of GDP ignores differences between Serbia and the EU member states. EU member states have better credit rating than Serbia, and therefore they are borrowing at much lower interest rates than Serbia.[3] As a result interest costs for Serbia at a debt of around 70% of GDP are approximately equal to the costs developed countries have with a public debt of over 100% of GDP. When it comes to the relation of the public debt to GDP, in case of Serbia, an additional problem is that about 80% of the debt is in euros so each euro depreciation by 1% leads to an increase in the share of debt in GDP by about 0.6 percentage points of GDP. The risk of the public debt of Serbia is also higher because over 60% of the debt[4] is related to foreign creditors, increasing the risk of a sudden stop of Serbia's funding.

2. How would fiscal deficit reduction affect the economy?

Critics of fiscal consolidation as its huge flaw suggest that it will lead to a further decline in economic activity, employment and income of citizens. Although this estimate is correct, it ignores the negative effects that a lack of fiscal consolidation would have on the economy.

2 Formal requirement for savings measure to affect the growth of the fiscal deficit is that the fiscal multiplier is greater than its critical value which is for Serbia is about 1.

3 Serbia occasionally borrows at low interest rates, as is the case with the Arabian loan, but this should not to blur the fact that the average interest rate at which Serbia borrows, as in the period of previous also during this government, is high and are in averaging around 5% annually, in euros.

4 Besides, one part of the public debt refers to domestic banks which are in foreign ownership.

Box 1. Credibility of fiscal policy and transparency of public finances in Serbia

Official data which are being published every month by the Ministry of Finance do not include all expenditures, which should be included according to the international public sector accounting standards. The consequence of this is that announced expenditures are lower, and this also means that the announced deficit is lower than the actual one. This problem in Serbia exists in for a long period, but it is more and more pronounced because the expenditures which were not included in the monthly reports (so called "below the line expenditures") are growing fast. Expenditures "below the line" include different positions, such as credits to state owned companies for which there is a minimal chance that they will be returned by the company (hence these "credits" are de facto subsidies, e.g. Železara Smederevo), state guarantees for credits of the public companies (Srbijagas, etc.) which are almost certain to be returned by the state, and other. While the expenditures "below the line" 3-4 years ago were about 05-1% of GDP, now they are close to 2% of GDP. As a result it is possible at the same time to find data in the Government documents that confirm the public debt in this year is around 6% of GDP or 8% of GDP depending weather the expenditures "below the line" are included or not.

The lack of transparency in public finances is particularly concerning due to the fact that the representatives of the Government at the end of the previous year announced that during 2014 data on public finances will, for the first time, include all income and expenses. It is confusing that the representatives of the Government claim that the data on expenditures include the below line positions, although the data on the website of the Ministry and in the Newsletter of public finances still do not include the data "below the line". The Ministry and the Government certainly have up to date and complete data on revenues and expenditures, but transparency means that these data are available on a monthly basis to all interested: investors, analysts, citizens.

Data on public debt of Serbia are not fully reported according to the international public sector accounting standards. There are differences in the scope of the public debt as well as in the method of calculation of its relation to GDP. Therefore, representatives of international financial institutions, private investors and analysts usually correct the official data on public debt, and as a result in different publications there are different data on the extent of the public debt of Serbia in euros and its share in GDP. It is relevant that the Fiscal Council more than two years ago published a document in which it suggested how to adjust the statistics of the public debt of Serbia with the international practice.

A lack of transparency about public finances causes the lack of trust from investors, international financial organizations and other, in the economic policy of the Government. The sensitivity about the problem of the lack of transparency in the world is particularly increased after a negative experience with Greece. It is therefore important to include "below the line" expenditures, in the shortest period possible, in the monthly data on revenues and that the data on public debt is entirely published in accordance with international accounting standards.

Fiscal deficit reduction almost always leads to the reduction in the economic activity. The mechanism is relatively simple – reduction in government spending cannot be compensated in the short term with the growth of other components of demand (private investments, private consumption and exports), thus total demand and GDP decline. Exceptions are very rare and they happen in situations when some country implements savings measures together with other reforms which improve economic environment, and at the same time countries, its most important economic partners are in expansion. In such circumstances economic activity does not fall because a fall in state consumption is compensated with the growth of private investments, private consumption and exports. However, this set of circumstances, which leads to a so called expansive fiscal contraction, happens relatively rarely, and in recent economic history Ireland and Slovakia are the most famous examples.

The possibility that expansive fiscal contraction happens in Serbia is practically non-existent, even if along with fiscal consolidation other reforms would be implemented, because its relevant environment is far away from the expansion. Therefore fiscal consolidation in Serbia will, as it was the case with most other countries, lead to certain fall in economic activity. How big this fall will be and how long will it last largely depends on Serbia, i.e. the intensity and structure of fiscal consolidation, and the content of policies and reforms. If fiscal consolidation would be strong and if alongside it the reforms of the economy and antirecession measures would be implemented, fall in economic activity could be relatively short-lived and moderate, and would last one to two years.[5]

5 The effects of fiscal consolidation and reforms depend on circumstances that are not controlled by the government, as trends in the international environment, particularly in the EU. The recovery of the EU would favorably influence the growth of foreign investments and credits, as well as the growth in demand for products from Serbia, which would mitigate the impact of the fall in government expenditure on GDP. In contrast, possible new recession in the EU would additional boost negative effects of fiscal consolidation on GDP growth.

The lack of fiscal consolidation would basically mean a continuation of the fiscal policy from the last few years, i.e. the continuation of the policy of high fiscal deficit and rapid growth of public debt. The result of such policy is the stagnation of the economy with stronger tendencies towards recession, and such policy could, in a relatively short period of time, end with the bankruptcy of the state. It is estimated that the delay of fiscal consolidation would result in a drop of GDP of about 1-2%, with the growing probability that the state goes bankrupt, which would lead to a drop of GDP of 5-10%.

Possible bankruptcy of the state would negatively affect the Serbian economy and public finances in a longer period of time. The State would not have access to commercial borrowing for many years, and the due debts and future deficits would had to be financed by the loans from uncommercial creditors (international financial organizations and other states) and the sale of state assets. It is certain that the amount of uncommercial credits would not be high which would mean that the fiscal deficit, and thus the expenditures of the state, would have to decrease significantly in real term. In this case, the state would simply have no choice - it would have to decrease the salaries, pensions, subsidies etc., to the level of available resources, and the available resources would be more modest than in the case of application of fiscal consolidation.

3. Consequences of alternative dynamics and structure of fiscal consolidation.

From the standpoint of recovery of the Serbian economy it is more favorable to carry out decisive fiscal consolidation, in parallel with the reform of the economic system. Implementation of a strong fiscal consolidation, which would in the next 3-4 years stop the growth of public debt to GDP ratio, alongside the reform of the economy, poses a condition for the growth of private investments, and hence employment and wages in the private sector. Strong fiscal consolidation with which savings of about 2.5% of GDP in the first year would be achieved, and then continuation with austerity measures in the next 2-3 years until the fiscal deficit is reduced to below 3% of GDP, would lead to moderate and short-term drop of GDP, after which the GDP would begin to grow.

However, such fiscal consolidation is politically unpopular because it implies that Government decisions will in the next few years reduce real incomes of a large number of citizens (public sector workers, pensioners, recipients of subsidies, etc.) which are financed by the state. People whose income depends on the state, along with family members, represent a large percent of voters[6], and the reduction of their incomes would certainly influence the decline in popularity of the Government. Therefore, the Government is reluctant to take necessary measures, mitigates the announced measures, and adopted measures are not implemented consistently.

Partial fiscal consolidation would basically mean a continuation of a policy which has been carried out for several years, and such policy has less and less confidence of investors. Investors have been somewhat understanding for delays of consolidation in the period of the previous coalition government, but they expected that after the formation of the new government strong fiscal consolidation will be implemented. Furthermore, such consolidation was announced by the Prime Minister, and its delay brings into question the credibility of the Government. Because of a long history of delays and mitigation of announced measures policy of uniform consolidation would probably not quickly gain the confidence of investors. Therefore, in the case of slower fiscal consolidation we would at the same time have a moderate drop in government spending but also the decline in private investments, because investors would be restrained.

Delaying or mitigation of fiscal consolidation is probably a short-sighted policy, even from the standpoint of political interests of parties forming the actual government. Delays in fiscal consolidation lead to the accumulation of problems and this can lead to a public debt crisis, followed by a decline in GDP, employment and income of citizens, including pensioners and public sector employees. In that case, it is almost certain that it will lead to a significant drop of support for the actual government. Therefore, from the standpoint of political interests of the members of the Government it would be better that unpopular measures are being implemented from the beginning of its mandate, in order to provide positive results in the second half of the mandate, and be capitalized in the election.

Besides the dynamics of fiscal consolidation an important issue is the structure of savings within fiscal consolidation. Savings of 5% of GDP can be achieved using different methods, and each of these methods has different effects on the growth of the economy, functionality of the public sector, economic inequality and political popularity of the government. The structure of fiscal consolidation will reveal to what extent each of these goals are taken into account during the process of creation of the savings measures.

6 The number of pensioners is 1.7 million while the number of employed in the public sector, including the employees in other state companies, is about 750 thousands.

From the standpoint of the economic growth it is important that savings are not being made on the account of public investments, which are already low, and also not to reduce the investments in the activities which are crucial for the economic growth, such as modest investments in education and science. For the growth of the economy it would be good to achieve savings mainly on current expenditures which are oversized in relation to the strength of the economy, and these are expenses for employees in the public sector, pensions, subsidies and other forms of assistance to state owned companies. It would be good to create certain space for implementation of incentive antirecession measures through savings on current expenditure. Suppressing the gray economy could contribute to the reduction of the fiscal deficit, while it would also affect the improvement of economic conditions. Abolition/reduction of subsidies which distort equal conditions for doing business would also be good for economic recovery.

From the standpoint of the functioning of the public sector the most favorable savings are the ones which refer to unproductive spending, starting from the abolition of unnecessary jobs, savings on public procurements, to abolition of unnecessary institutions. Certain savings could be made through privatization of some state institutions, as well as through exclusion from the state financing of institutions which offer low quality services. Certain savings, such as announced highly progressive reduction of wages, are not good from the standpoint of efficiency of the labor market and the functioning of the public sector. Such savings would further foster negative selection, which exists in the public sector for decades, reduce the quality of services and encourage corruption. Well regulated state is crucial for the progress of the economy and society, and this cannot be achieved with egalitarianism. Therefore, from the standpoint of the public sector operation it would be most appropriate that wages within fiscal consolidation decrease linearly, with the protection of the minimum wage, and that the change in relative wage relations are achieved in a systematic way through salary ranges.

Saving measures as part of the fiscal consolidation should be designed so that through them the poorest class of population is protected, and this means that recipients of minimum pensions and minimum wages, as well as social assistance recipients, should be exempted from savings. However it is not justified that the fiscal consolidation introduces progressive reduction of salaries and pensions, because it would mean de facto redistribution from middle class (doctors, judges, professors, senior officers and others.) to poorer citizens.

From the standpoint of the Government popularity, savings which affect a small number of citizens - potential voters are desirable. Undoubtedly the best example of such savings is a substitute of expensive loans with cheap ones, but more than once we wrote in the Quarterly Monitor that the potentials of this undoubtedly good saving measure is more than modest - by replacing a billion euros of expensive loans with cheap loans savings of 30-40 million euros per year would be achieved. All measures which abolish unnecessary spending (excessive use of expensive cars, buying unnecessary goods and services, and others.) are politically profitable. Some savings which affect a small number of people, such as the solution of the status of loss-making state owned industrial companies, are good from the standpoint of the economy and the public sector also, but their influence on the popularity of the Government is uncertain because of possible strikes. Savings which would be achieved through high progressive reduction of public sector wages and pensions are appropriate from the standpoint of the popularity of the government, because in this way most employees/pensioners, who are also voters, are protected, but this would have a negative impact on the overall functioning of the public sector.

Conclusion

Stalling and indecisiveness of the Government in the implementation of fiscal consolidation has launched a flood of proposals challenging the need for fiscal consolidation or proposing "light" measures for its implementation. Contesting fiscal consolidation is not new, it exists in other countries also and it is a consequence of the effects of political factors on the economy. Representatives of interest groups are trying to avoid, postpone, or at least reduce the savings which refer to them. For that purpose assessments that the situation is not so serious, and thus big savings are not necessary are released in public. Savings measures, which should normally be realized within fiscal consolidation, are proposed, but their effects are being extremely overestimated in order to prove that the reduction of wages and pensions is not necessary. Thus, for examples, it is argued that in Serbia's government sector has twice as many employees per 100 citizens than other countries, and that this is a consequence of employing of 200 or 300 thousands party activists after 2000. From the above mentioned it can be concluded that the fiscal deficit can be eliminated with the lay-off of the party-employed clerks. There is no doubt that there is a surplus of employees in the public sector and that this is partly a consequence of party-employment, but it is for an order of magnitude smaller and measured by tens, not hundreds of thousands. There are also claims that the fiscal deficit can be eliminated with a more efficient suppressing of the gray economy. In this case also, there is an extreme overestimation of the potential of the gray economy suppressing - possible additional revenues amount to about 1% of GDP, and the deficit should be reduced for 5% of GDP. In a similar way savings which could be realized based on the replacement of expensive loans with the cheap ones, abolition of unnecessary agencies or reduction of subsidies to state owned companies were extremely overestimated. Mutual characteristic of previous proposal is that they would lead to insufficient fiscal consolidation, and then to prolonged recession, with the possibility of bankruptcy of the State.

Disposal of consolidation reasonably raises the question of whether we as a society will in an organized way regulate Public Finances, or will we leave it to disorganization i.e. bankruptcy? Both choices are legit, although we believe that the first option is better.

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