

HIGHLIGHTS

Highlights 1. Comparative Analysis of Alternative Tax Reform Proposals

Milojko Arsić*

A study “Tax Policy in Serbia: Looking Forward” proposes reforms, which significantly change the structure of the tax system towards lowering the fiscal burden of labor and expanding the fiscal burden on consumption. The proposal refers to a reduction of wage tax burden through lower contribution rates, while resulting public revenue losses would be compensated through an increase of the general and perhaps of the lower VAT rate. Alongside those reforms, an income tax reform would be implemented so that the existing combined model of taxation would be replaced with a proportionate income tax or with a simpler form of a dual or synthetic income tax. It is estimated that the income tax reform will be neutral from the revenue point of view or bring in additional revenue of around 0.5 percent of GDP, depending on the impact of other tax reforms and the public spending reform. The study also contains the proposal for a property tax reform and proposes improvements in taxing corporate profits.

Soon after announcing the above-mentioned concept of reforms, a set of alternative proposals followed, with a proposal by Deputy Prime Minister Mladjan Dinkić having special weight because it contains a relatively significant lowering of the fiscal burden on labor – not through lower contributions, but through lower taxes.

The resulting decline in public revenues would be offset by raising the VAT rate on almost all products currently subject to a lower VAT tax rate, with the exception of only few staples, which would be subject to a zero VAT tax rate. The proposal by Deputy Prime Minister Dinkić carries some similarities but also differences compared with proposals from the abovementioned study.

Proposed tax reforms can be assessed from the point of view of their impact on macroeconomic stability, economic growth and job creation. The listed criteria are not independent because, for example, macroeconomic stability is an important determinant of long-lasting sustainable economic growth. Therefore any proposals that threaten macroeconomic stability also threaten economic growth.

The implementation of reforms presented in the Study would also have an impact on other macroeconomic ag-

gregates, such as imports and exports, but that is not the focus of this Highlight.

The Impact of Alternative Tax Reforms on Macroeconomic Stability

Under unchanged conditions, tax reforms directly affect the fiscal deficit, and through the fiscal deficit also have an impact on macroeconomic stability. Reforms, which increase the fiscal deficit at the same time threaten macroeconomic stability, while reforms that lower the fiscal deficit strengthen macroeconomic stability. Reforms that leave the share of public spending in GDP unchanged are neutral to fiscal revenues and have no impact on the fiscal deficit and macroeconomic stability. Therefore, different reform proposals can be assessed by their impact on the fiscal deficit.

The study “Tax Policy in Serbia: Looking Forward” contains the condition that the tax reform in Serbia should be revenue neutral or generate additional revenue of between 0.5 percent and 1% of GDP (depending on the results of the public spending reform). Therefore, the implementation of the tax reforms proposed in the Study, under unchanged conditions, would have a positive impact on macroeconomic stability. The Table 1 shows two combinations of reforms, which achieve a relatively significant fiscal relaxation on labor, while both are similarly neutral to revenues.

Table 1. The Revenue Impact of Reforms Proposed in the Study “Tax Policy in Serbia: Looking Forward”

	Suggested measure	Revenue effect, % GDP	Suggested measure	Revenue effect, % GDP
Decrease in contributions rates	Decrease in contributions rates for 1/5	-1.85	Decrease in contributions rates for 1/5	-1.85
VAT increase	Increase in VAT rate from 18 to 20% and reduced rate from 8 to 10%	1.35	Increase in VAT rate from 18 to 20%, and transfer of non-staple products ¹⁾ from 8% to 20% rate	0.9 0.5
Personal income tax reform	Non-taxable amount 10,000 RSD, tax rate 15%	0.55	Non-taxable amount 10,000 RSD, tax rate 15%	0.55
Net revenue effect, % GDP		0.05		0.1

The listed impact would be achieved by transferring the following non-staple products currently taxed by the lower VAT rate (8%) to the general VAT tax rate (20%): computers, hotels, newspapers, tickets for cultural events, natural gas and artificial fertilizers.

According to the proposal made by Deputy Prime Minister Dinkić, the fiscal relaxation of labor would be achieved through an increase of a tax-free part of the salary to 16,500 dinars as well as through a cut in wage tax to 10% from 12%. The implementation of this measure would lead to a loss in fiscal revenue equivalent to 1.3 percent of GDP. To compensate the lost revenue, it has been proposed to move all the products, except for

* Faculty of Economics, University of Belgrade and FREN.

** USAID Serbia Economic Growth Activity (SEGA).

staples, currently taxed by 8% to the higher tax of 18%, while staples (bread, milk and related products) and newspapers would be subject to a zero tax rate. The proposed VAT reform would result in significant additional revenues equivalent to around 1.4% of GDP. That means that the tax reform proposed by Deputy Prime Minister Dinkić would also be revenue neutral and therefore sustainable from the fiscal and macroeconomic point of view. However, it is assessed that there is certain risk related to the implementation of the proposed change in VAT taxation – that a list of products subject to the zero tax rate would be widened or that some products remain subject to an 8% VAT tax rate. The previous assessment is based on expectations that the public will be explicitly against any significant tax hikes and thereby price hikes for products such as medicaments from so-called positive list, school books, fruits and vegetables, utility services, etc. In case of a failure to apply the general tax rate to the listed products, the revenue impact of the VAT reform would be lesser, so that the entire reform proposed by Deputy Prime Minister Dinkić would have a negative impact on macroeconomic stability.

In the introductory part of this Highlight, it was alleged that many proposals for tax reforms contain the idea that some of existing taxes, mainly the taxes and contributions applied to salaries be reduced and that other taxes remain unchanged. This begs a question – whether fiscally and macro-economically sustainable tax reforms, that would lead to a significant decline in tax revenues as a share of GDP (for instance by 1 percentage point of GDP), to be offset by the reduction of public spending of the same magnitude, are possible in Serbia? This alternative needs to be considered in more detail because it enjoys significant support by some experts and businesses. The sustainability of a tax reform that would lead to a reduction in tax revenues as a share of GDP can be assessed through its comparison with a revenue neutral reform.

The implementation of a revenue neutral tax reform, due to the existence of a structural fiscal deficit, demands the cut in the share of consolidated public spending in GDP over the next four to five years, by at least 3 percentage points. Should this not happen – Serbia's public debt would continue to rapidly expand towards unsustainable levels. To lower the share of public spending in GDP by at least 3 percentage points, while not paving the way for an increase in public investment and spending on interest rate payments, it is necessary to cut the share of current public spending in GDP by 5-6 percentage points over the next few years. The mentioned cut in the share of current public spending in GDP requires the spending on wages and pensions to rise twice as slow as the real GDP growth over the next four to

five years. Besides, it is necessary that the share of all other current spending items (spending on purchases of goods and services, subsidies, budgetary lending, etc) to significantly fall in relation to GDP.

If tax reforms would lead to lower public revenues – a sustainable fiscal policy would require an additional cut in spending to match the volume of the lost revenues in comparison to results of a revenue neutral reform. For example, if a loss in public revenues amounts to one percentage point of GDP, it would be necessary to cut the share of consolidated public spending in GDP by more than 4 percentage points of GDP, while current spending would fall by 6-7 % of GDP. To achieve this, it is necessary to make even steeper cuts in all components of the current spending than in the case of a revenue neutral reform.

Additionally, a reduction in public spending, although appearing to be desirable at first sight, could steer lower the volume and the quality of public sector services. The cut in the volume and quality of public sector services could jeopardize social stability as well as economic growth. If the mentioned cut in public spending was to fail (which seems likely), it would result in a high fiscal deficit and an accelerated growth in public debt. High sovereign indebtedness would negatively affect the country's credit rating, the level of foreign investments, etc., which would have a negative impact on growth.

To summarize the above mentioned, it means that over the next few years in Serbia only tax reforms that keep the share of public revenues to GDP unchanged, or those that lead to a modest increase in public spending will be macro-economically sustainable. Tax reforms that would lead to a significant loss in tax revenues against GDP would have as a consequence declining availability and quality of public services or, which is more likely, an expanding share of public debt towards unsustainable levels.

The Impact of Alternative Tax Reforms on Economic Growth and Employment

Tax reforms affect employment and economic growth if they change relative prices of production factors (labor for example) and if they affect macroeconomic stability. Both proposals for tax reforms (the study Tax Policy in Serbia: Looking Forward" and the proposal by Deputy Prime Minister Dinkić) contain a significant reduction in fiscal burden on wages. But for the relaxation of the fiscal burden on production factors to have a positive impact on growth – it will be necessary that a significant part of the fiscal relaxation stays in companies, i.e. not to be largely used for net wage increases. The

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distribution of fiscal relaxation between employers and employees will depend on the labor market, the strength of the trade union as well as on the state, which acts both as a regulator and the biggest employer. Having in mind a high unemployment rate in Serbia and relatively weak trade unions in the private sector – it is expected that a significant part of the fiscal relaxation will remain at the companies' disposal.

The division of the fiscal relaxation will largely depend on how the state behaves. As a regulator, the state determines the minimum wage, while as an employer it determines salaries for around 600,000 employees. A responsible government's policy would assume that public sector wages financed from fiscal revenue (for around 450,000 employees) rise in the coming years at a much slower pace than GDP, so that their share in GDP shrinks to around 8%. The state should also ensure that wages in public companies (around 150,000 employees), which are now above the private sector wages, rise in the future in line with productivity and in line with private sector wage growth, which means that they should not depend on changes in the tax policy.

To summarize the previous, it means that a responsible policy of the state would ensure that a relatively significant part of the fiscal relaxation stays with companies and is used for new investments and new job creation. However, it also begs a question whether the impact of fiscal relaxation would be relevant from a macroeconomic point of view, i.e. whether the relaxation would significantly influence economic growth and new job creation. If the fiscal relaxation was equivalent to 2% of GDP and if it was to be shared between the companies and workers at a 50-50 basis, the companies would be left with around 1% of GDP (around 300 million euros) for investments. A VAT tax rate increase would, sooner or later, hit consumers so that the ultimate result of proposed reforms would be a decline in domestic spending and an increase in domestic savings. Expanding domestic savings, which has for decades been significantly lower from investments in Serbia, represents a key condition for a lasting, sustainable economic growth. With the implementation of the proposal by Deputy Prime Minister Dinkic – the labor costs would significantly fall, but the decline would be almost 30 percent lower than the one achieved through a cut in contributions by one fifth.

It has been previously proved that proposed reforms would not lead to an increase in fiscal deficit and that they would not endanger Serbia's macroeconomic stability. Numerous econometric research activities have confirmed that macroeconomic stability represents one of the important determinants of economic growth. Low and

predictable inflation, an absence of sharp and sudden exchange rate swings, etc., are beneficial for economic growth. On the contrary, high and variable inflation and sudden exchange rate swings increase the cost and risks of doing businesses, which negatively affects economic growth.

It is expected that labor cost cuts lead to higher labor demand. Higher demand for workforce would be partially financed from higher domestic savings, which would result from the tax reform, while the rest of financing would come from other sources. If we assume that contributions are cut by 20% and that a half of the reduction is shifted to lower labor costs, the labor costs for an average salary would fall by around 3%. Considering that the value of the elasticity coefficient of workforce demand¹ is typically 0.5 it means that a reduction in labor costs by 3% would as a result lead to a 1.5% increase in labor demand or around 30,000 workers. According to the proposal of Deputy Prime Minister Dinkić, the workforce demand would be lower for a third due to weaker fiscal relaxation of wages.

The existing fiscal burden on salaries in Serbia is relatively identical for all wages. The implementation of proposed reforms assumes more progressive wage taxation. The greatest level of progressiveness would be achieved with higher tax-free wage and higher tax rate. According to analysed scenarios, the greatest progressiveness would be achieved with a 20% income tax rate and a tax-free threshold of 16,500 dinars. The remaining two scenarios – the proposed income tax rate of 15% and a tax-free threshold of 10,000 dinars and the one proposed by Deputy Prime Minister Dinkic for income tax rate to be cut to 10% and the tax-free threshold constituted at 16,500 dinars – would result in a lesser degree of progressiveness.

Table 2. Fiscal Burden of Wages – For Each 100 Dinars of Net Wage

Wage level	Current tax rates	Reform proposals from study "Tax Policy in Serbia: Looking Forward"		Proposal of deputy Prime-minister Dinkić
	Wage tax rate 12% non-taxable amount 6,500	Decrease in contribution rates of 20%, wage tax 20%, non-taxable amount 16,500 RSD	Decrease in contribution rates of 20%, wage tax 15%, non-taxable amount 10,000 RSD	Wage tax 10% non-taxable amount 16,500 RSD
50% of average wage (minimum wage)	61	44.9	49.1	49.8
75% of average wage	63.3	53.5	53.1	54.1
100% of average wage	64.5	58.2	55.2	56.4
150% of average wage	65.7	63.1	57.3	58.7
250% of average wage	66.7	67.3	59	60.6
350% of average wage	67.1	69.2	59.8	61.4
500% of average wage	67.4	70.6	60.4	62

Increasing progressiveness in taxing wages implies that the cost of labor will decline the most for the group of

¹ See e.g.: Hong-Ghi Min (2007), „Estimation Of Labor Demand Elasticity For The RMSM-LP: Revised Minimum Standard Model For Labor And Poverty Model“, *International Business & Economics Research Journal*, Vol. 6 – Number 7.

weaker paid workers, while the labor cost cut for better paid workers will be lower. Furthermore, in the case of implementing the proposal which implies the greatest increase in progressiveness (tax rate of 20% and tax-free threshold of 16,500 dinars) – the fiscal relaxation of high wages would partially grow compared to the present state of affairs. Changes in the structure of the fiscal burden on wages that would mostly cut the labor cost of the least paid workers are in line with the unemployment structure in Serbia – because the greatest unemployment rate is within the group of lowest paid workers.

Conclusion

With Serbia facing a high structural deficit, it is assessed that all proposed sustainable tax reforms should be revenue neutral or to generate some additional revenues. A possible additional loss in tax revenues would almost certainly endanger fiscal sustainability and macroeconomic stability of the country. Tax reforms presented in the study „Tax Policy in Serbia: Looking Forward“ are

designed to generate the same or somewhat higher fiscal revenues as a share of GDP, therefore they contribute to firmer macroeconomic stability. Tax reforms proposed by Deputy Prime Minister Dinkić, strictly implemented in line with the proposal, would also be revenue neutral. However, it is assessed that in this case there is a real threat of stopping short of transferring almost all products on general VAT tax rate, that because of the political resistance of the public. Proposals by the authors of the study, too, as well as the proposal by Deputy Prime Minister Dinkić would lead to lower average fiscal burden on wages, as well to higher progressiveness in taxing wages. An expected result is an increase in domestic savings, investments and job creation. For the reforms to yield positive results, it is necessary that the fiscal relaxation on wages is not used for wage hikes in public companies, education, health and state administration or for higher minimum wage. A wage increase in the public sector and the minimum wage increase should reflect economic fundamentals, and not to be part of tax reforms.

Highlights 2. Political Economy of Employment Cuts in Local Administrations

*Sonja Avlijaš**

Serbia was hit by the global economic crisis during the period in which increasing efforts were being directed towards greater fiscal decentralisation, which is perceived as one of the essential reforms on Serbia's path towards the EU. Since the onset of the crisis, Serbia has been facing serious fiscal pressures at all government levels, and a reduction of public sector expenditures has been identified as one of the most important adjustment mechanisms to the crisis. Since Serbian authorities have gone about reducing public spending through cuts in local administration employees and cuts in transfers to local self-governments (among other measures), these measures have somewhat impeded the process of fiscal decentralisation, which delegates additional responsibilities to local authorities. Having this in mind, this Highlight attempts to throw light on some of the trade-offs between economic and political aims of reform processes in Serbia.

The revised stand-by arrangement with the IMF called

for additional, more severe, measures to reduce public spending, which would include a freeze on the nominal wages of government employees (including employees of public enterprises) through 2010, an extension of the nominal freeze on pensions through 2010, a freeze on hiring employees (with very limited exceptions), a reduction of employees in public administration, a reduction in transfers to local governments, and sharp reductions in the discretionary budgets of all budget users.

The rationalisation of the number of employees in the public administration was administered through the adoption of legislation which limits the number of employees at local and central government level in December 2009. According to the Law on the Maximum Number of Employed in Local Administration, the number of full-time employees in the local administration was capped at four persons per 1,000 inhabitants¹, which means that the total number of workers in local governments financed from the local budgets is expected to be reduced down to 32,000². On the other hand, the reduction in transfers was simply illegal, under the existing legislative framework.

When it comes to fiscal decentralisation, Serbia boasts of a substantial, although incomplete, legislative fra-

* *Quarterly Monitor*, FREN.

Highlights is based on the paper „Political Economy of Local Level Public Sector Employment: A Case Study of Serbia“, which the author presented with Milica Uvalic (University of Perugia) at a regional London School of Economics research conference in Zagreb.

¹ According to the latest Census, Serbia's total population amounts to 7,498,011 persons.

² The Law therefore envisages a reduction in the number of employees by between 10 and 30 percent in 110 municipalities with surplus employment.

mework which recognises its importance and promotes its principles. Nevertheless, more political will is needed to ensure thorough implementation of the existing legislative framework and to push for further reforms, primarily in the domain of greater autonomy of LSGs in public revenue management.

A number of laws have been adopted over the last few years, which have increased responsibilities of local self-governments, especially in comparison to their 1990's levels. One of the most relevant legal acts for fiscal decentralisation is the Law on Financing of Local Self Governments (hereinafter referred to as the Law on Financing of LSGs), adopted in 2006, which regulates the sources of financing for local authorities. This Law determines which types of revenues are own revenues of local self-governments (the most important of them being property tax), as well as the amounts and criteria for transfers from the central budget.

Following adoption of the 2006 Law on Financing of LSGs, a two year deadline was given to all municipalities to take over the collection of own revenues (property taxes, communal fees etc.) from the central government, which included the establishment of local tax administration units. As of January 1st 2009, all municipalities in Serbia assumed this role, which was expected to improve the basis for the collection of local taxes as well as increase local tax revenues. Prior to the adoption of this Law, property tax was being passed onto local self governments from the central Tax Administration, which collected it in the name of LSGs.

Since the onset of the economic crisis, fiscal pressures have significantly influenced LSG revenues. As part of the stand by arrangement with the IMF, transfers to LSGs were cut by 15bn dinars (around 150mn euros) in 2009, and such practice continued into 2010. As we already mentioned, in this way, the 2006 Law on Financing LSGs was broken by the central government, while the exact criteria for cuts in transfers to LSG remained obscure. Although it is clear that the Ministry of Finance had to break the Law in order to maintain the country's macroeconomic and fiscal stability, LSGs were once more left in darkness regarding the process according to which they receive sources of funding from the central authorities. Such non-transparent actions on behalf of the Ministry of Finance threaten to impede the already fragile process of adoption and implementation of a legal framework which is to mainstream the participation of municipalities in the process of fiscal decentralisation. In addition, although the 2006 Law on Financing LSGs established a Commission for Financing LSGs, this Commission is yet to gain any prominence, since in reality, it has had no leverage in times of economic crisis

and fiscal pressure, when it was expected to protect the interests of LSGs.

Moreover, Article 3 of the 2006 Law on Financing LSGs, which states that the Republic is obliged to allocate adequate resources to local self governments each time it transfers or entrusts new obligations to them, is also consistently being breached. An example of such breach came following the adoption of the 2007 Law on the Territorial Organisation, which increased the number of towns in Serbia from 4 to 24, that way increasing responsibilities of those LSGs which were „converted“ into towns. One of the responsibilities assumed by these new towns was the formation of the communal police, following adoption of the Law on Communal Police in July 2009. As the Law came into force in January 2010, all 24 towns have had to establish communal police, whose purpose is to deal with communal problems such as illegal parking, waste disposal etc. Although these newly established towns have assumed this obligation, no additional funds have provided for them from the central authorities, so communal police has to be financed from LSG own revenues.

Some of the preliminary findings of an ongoing research endeavour conducted by FREN on behalf of the USAID's MEGA project, which assesses general employment patterns in the local public sector across Serbia, serve to further argue that the choice of fiscal austerity measures have impeded the process of fiscal decentralisation. Data on the current situation have been collected in most municipalities by now, as well as the information on what will happen (or is planned to happen) as a result of the employment reduction legislation. The sample included 7 municipalities³, geographically spread out across the Republic of Serbia, which diverge in socio-economic characteristics and size, as well as their level of dependency on central government transfers.

While some of the analysed municipalities have already completed the process of cutting the size of their administration, others are still delaying it, since they cannot come up with transparent criteria for making their employees redundant, and they are also struggling with finding the resources for severance packages, which are required by the 2005 Labour Law, and are not provided by the central government. This has brought LSGs from the research sample into an absurd situation of having to adhere to the strict labour regulation, while at the same time making workers redundant based on obscure criteria which are in conflict with the law.

Research also shows that in some cases, it has cost LSGs more in the short run to make workers redundant, ra-

³ Kragujevac, Kovačica, Leskovac, Smederevska Palanka, Sombor, Zrenjanin and Užice.

ther than to keep them, which represents a particular burden in times of severe fiscal pressures. For example, in order to adhere to the new legislation on the number of employees, some municipalities have opted to fire their cleaning staff. However, since cleaning is a fixed cost, they had to hire a private agency to perform cleaning services instead, which was also obliged to take over the cleaning staff which was made redundant from the administration. Although the cleaning services are now financed from a different budget item, they do not cost them less than the total cleaners' wage bill, so no savings have been made in public expenditures as a result of this move. At the same time, they had to pay out severance packages to all of the cleaners they made redundant, which in most cases amounted to their annual salaries and represented a serious burden for municipal budgets.

In most LSGs, those employees who left the public administration first were elderly workers who could obtain the right to early retirement. Thus, the most common scenario was for them to take their lump sum severance payments and retire. In that way, they merely spilled over to the central government expenditures, in the form of pensions. There were also cases of the workers who registered with the National Employment Service, following their departure from the public administration, with the same effect on central government expenditures. It is therefore clear that the ongoing cuts in public employment are completely unsustainable for the state budget, unless they are concurrent with efforts to generate employment in the private sector, since they only result in transferring state budget beneficiaries from one "tap" to another.

Moreover, since the 2009 Law on the Maximum Number of Employed in Local Administration does not regulate employment in public enterprises, the only instrument for curbing their expenditures has been the freeze of the 2009 wage bill, which is supposed to continue at least until September 2010. At the same time, subsidies to these enterprises from the local budgets continue and have even increased as the market prices of oil and other inputs grow, even when they are not directly spent on wages.

During fieldwork, substantial evidence has been found to support the claim that the announced reductions in the number of employees in public administration will not result in significant reductions of wage expenditures, especially in larger LSGs. For example, those municipalities which were transformed into towns with the adoption of the 2007 Law on Territorial Organisation have had the obligation to establish the Mayor's office as well as the City Council, and along with it, to finance

their wages since 2008. Individual complaints of some LSGs to the Ministry of Finance that these were officials and should not be included into the total number of employees in public administration were granted, so their numbers and wages are not being included into the total wage bill which has been capped by the Ministry. Moreover, we already pointed out that towns were obliged to establish communal police, according to the 2009 Law on Communal Police, and that they are now allowed to hire additional staff as members of the communal police, as long as they are able to finance them from their own revenues. Additional space for hiring workers also exists in the newly established local tax administrations.

Therefore, the main findings suggest that LSGs have found ways to cover current expenditures on staff, while cuts in transfers and fiscal revenues have severely impeded their ability to invest into local economic development. Following years during which LSGs managed to shift their responsibility away from merely administering wages and fixed operational costs towards investing into the development of the local community, have now shifted back to basic administration of fixed costs and careful management of current expenditures. While their transfers have been reduced, their lack of ownership rights over the public property they use (expected to be regulated once a new Law on Public Property is adopted) makes it difficult for them to attract capital through any form of co-financing, or issue debt guarantees on borrowings. Commercial banks have thus far been the only ones willing to work around these rules, and they lend to the municipalities quite expensive capital, in comparison to other sources of finance LSGs could use, if the right kind of legislation were in place.

Finally, since unemployment is a huge and long-term problem of the Serbian economy, the envisaged freeze and reduction in public sector employment will only increase the structural problems of the Serbian economy further. Employment policy needs to be given a more prominent place and become fully integrated within the overall economic development strategy. Special attention should be given to policies, programmes and measures promoting private sector wage employment. Active labour market measures, such as training, counselling unemployed people, supporting self-employment, or organising public works, are completely marginalised. They make up only one thousandth of GDP, and the budget does not even envisage their nominal growth in 2009 relative to 2008 (Arandarenko, 2009). Related to these measures are also the reforms of the entire tax and contributions system. It is necessary to implement additional radical reforms, in order to decrease labour costs of firms and make them more competitive, stimulate fo-

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reign investments, and facilitate the formalisation of the informal economy.

Finally, since excess employment at the local level is mainly dominant among indirect budgetary users, such as local institutions and communal public enterprises, and to a lesser extent in local public administrations, it is clear that a reduction in the number of employees should be applied to the entire public sector, rather than limited to administration. By focusing efforts exclusively on the reduction of employees in public administration, perverse incentives could be created in local self governments (LSGs) to transfer workers from public administration into other institutions, which are indirectly dependent on the government budgets.

In conclusion, efforts towards fiscal decentralisation in recent years have at times shown to be giddy. Although a comprehensive set of laws have been adopted which have increased the autonomy of LSGs in matters of public finance, their implementation has often failed to produce the expected results. This has particularly been the case since the onset of the economic crisis, during which, as imposed by the conditions of the IMF SBA, the 2006 Law on Financing LSGs continues to be broken regarding transfers to LSGs. At the same time, in order for further reforms to take place, which would allow for easier access of LSGs to private capital, a series of new laws remain to be adopted, such as the Law on Public Property, Law on Public Debt, Law on Commu-

nal Activities etc. These laws would allow LSGs to seek alternative ways to finance local economic development and attract investment, through PPPs, issuance of municipal bonds and other types of partnerships with the private sector.

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Highlights 3. First Serbian Tax-Benefit Microsimulation Model – SRMOD

Jelena Žarković-Rakić*

When the global economic crisis hit Serbia's economy and the countries in the region in late 2008, economic policy makers started deliberating several stabilisation and stimulation measures. Most countries applied a similar strategy: measures planned long before the onset of the crisis, entailing cuts of personal income taxes and mandatory social security contributions and facilitating administrative procedures, and future major infrastructure projects were presented as instruments designed precisely to overcome the crisis (Arandarenko and Golcin 2009, p. 74). The impression is, however, that the public was sometimes confused by the frequent changes to the proposed measures and the abandonment of previously adopted solutions. Government, for instance, initially talked about increasing the value added tax as the way to cut the fiscal deficit in 2009, then went on

to deliberate the introduction of a solidarity tax on higher incomes. Ultimately, the economic authorities decided to base fiscal adjustment on the introduction of some minor *ad hoc* taxes on spending and on cutting public spending by freezing i.e. temporarily cutting above-average salaries in the public sector. Although the Government's selection of the latter measures was probably guided by specific macro-economic calculations, some equally important questions appear to have gone unanswered. For instance, no estimates were made whether the disposable household income would be more affected by raising the value added tax or by the introduction of the so-called solidarity tax; which parts of the population would actually be affected and to what extent, and whether the benefits, measured in additional tax revenues, would outweigh the losses? This brings into question the fiscal policy makers' current capacity to assess not only the budgetary effects of the alternative tax and benefit policy solutions, but the effects of these changes on *distribution, inequality, poverty and social exclusion* as well.

* Faculty of Economics, University of Belgrade and FREN.

Sophisticated models have been developed in the European Union to estimate the effect of the tax and benefit policies on the welfare of families, not only on average, but on every single household as well. The development of these models was launched by Professor Sir Anthony Atkinson in the United Kingdom in the late sixties. Thanks to his initiative, the initial TAXMOD developed into the EUROMOD, which became the common model framework from which specific national modules for all the “old” EU members were derived by 2004. The EUROMOD continued expanding after EU enlargement to the East and national modules have already been developed for most new EU members. A simpler version of this model, which is universally used in all OECD countries, is known as the Tax/Benefit Model. The EUROMOD has also been used as a platform for the design of relevant microsimulation models for the South African Republic and five Latin American countries.

The EUROMOD is a tax-benefit microsimulation model for the European Union. It allows for the research of the effects of these policies on income, poverty, inequality, social inclusion and work incentives. Given that it was designed independently of individual theoretical directions of thought, this model allows its users to apply in their research the approaches they themselves choose. As it is used in most EU member-states, this model simultaneously constitutes a framework for comparative research, based on a common database (and, one could say, knowledge) of tax structures and social assistance systems and maintained by the EU member-states at the national level.

Like other microsimulation models, the EUROMOD is based on microdata on households considered representative of the population that is the subject of interest. The model calculates each household’s disposable income by using the income elements in the micro-database (such as wages, income from capital and agriculture) and combining them with simulated tax and benefit values (see Table 1).¹ Thus, information on the *changes in the disposable household income* after the introduction of reforms of the tax and benefit policies or, for instance, of the social assistance eligibility criteria, is the main result provided by the EUROMOD. As an analytical instrument, the model allows for conducting “laboratory experiments” given that the effects of the reforms of the tax and benefit policies can be analysed even *before they are actually implemented*.

1 All calculations are made assuming that there is no tax evasion and that social assistance is claimed by all eligible households/individuals – which may result in the over-estimate of the taxes and benefits. More in: Sutherland (2001).

Table 1. Main Income Concepts in EUROMOD

Market income (employment and self-employment income, income from agriculture, income from capital, income from property (rent))
+ Social benefits (family benefits, pensions, unemployment benefit, social assistance benefits, housing ben
Further broken down into:
· Public pensions
Means-tested benefits
Non means-tested benefits
– Social insurance contributions (paid by employees, paid by the self-employed)
– Personal Income Taxes (income and other direct taxes)
= Disposable income

Source: Paulus (2009).

A team of researchers within the Foundation for the Advancement of Economics (FREN) started work in the latter half of 2009 on the first Serbian tax-benefit microsimulation model (SRMOD) based on the EUROMOD platform.² With support from Essex University researchers³, the work on the SRMOD was completed in early March this year, whereby Serbia became the first non-EU state in Europe to have a microsimulation tax-benefit model based on the EUROMOD platform. The SRMOD currently uses as its micro database the Living Standards Measurement Survey (LSMS), conducted in 2007 by the Statistical Office of the Republic of Serbia with World Bank’s support. In consultation with their Essex colleagues, the FREN research team opted for this database because it includes detailed information both on various sources of revenue and on paid taxes and claimed benefits. This allowed for conducting micro-validation (comparison of simulated and real values of benefits at the household level) with greater accuracy and thus for a more reliable estimate of the model’s conformity with the actual tax system and benefit policy. Policy rules on taxes and benefits also date back to 2007. Given that preparations are under way to conduct the European Union Statistics on Income and Living Conditions (EU-SILC) in Serbia as well, plans are to replace the current database formed on the basis of the LSMS by this micro database. The change of database is to be accompanied by the introduction of new tax and benefit rules within SRMOD.

The designed SRMOD provides a powerful instrument for analysing the effects of the existing and/or planned tax and benefit policy solutions. The opportunity to test a number of alternative scenarios of fiscal and social policy measures is of extreme significance to Serbia.

2 Work on the development of SRMOD was made possible thanks to the financial support of the Fund for an Open Society. We would hereby like to thank the Fund, as well as the lecturers and associates of Essex University and the Vienna-based European Center for Social Welfare and Research.

3 The microsimulation unit, which maintains and further develops the EUROMOD, operates within the Essex University *Institute for Social and Economic Research* (ISER). More details are available at: <http://www.iser.essex.ac.uk/research/euromod>.

Highlights

The recently announced tax policy reform (Arsić *et al.*, 2010), for instance, includes several proposals on how to change personal income taxation. Each of the proposed changes could be tested within the SRMOD to estimate the effects of the individual solutions on horizontal and vertical equity, poverty rate, inequality of income distribution, as well as the effects of the proposed measures on the amount of collected tax revenues.⁴ Fiscal policy makers would thus have at their disposal a greater number of criteria to assess the advantages of specific tax regimes.

FREN's research team, commissioned by the World Bank, is currently testing the effects of the draft law on social protection which is to be adopted in the latter half of the year. The new bill introduces changes in the social assistance eligibility criteria, with particular focus on assisting the rural segment of the population and families with more members. It envisages a different method of calculating the benefits, which is modelled after the OECD equivalence scale, whereby it takes into consideration the diverse needs of households depending on the number of adult and child household members. Whether the application of the new law will help cut the poverty rate, particularly amongst the rural population and large families, whether it will reduce the inequality of income distribution, and how much more money in the budget will have to be earmarked for this programme – these are merely a few of the issues to be tested via the SRMOD.

Apart from these current burning issues, there are particular advantages in using the EUROMOD (and thus the SRMOD) in the research of other, equally important problems. For instance, the EUROMOD has special potential for the assessment and comparative research of (European) tax and benefit policies focussed on protecting children *from social exclusion and poverty*. The latest improvements of the model have also rendered it an excellent instrument for estimating the effects of tax and benefit policies on the *labour supply incentives*. Finally, the EUROMOD allows for calculating variations in the total household income caused by a change in the employment status of one or more household members.

Although there are other microsimulation models capable of partly satisfying the needs of Serbia's policy makers and academia, such as, for instance, the OECD Tax/Benefit Model, the EUROMOD's specific features give it a value added over the existing similar models. Its flexibility allows new users to alter the fiscal and benefit policy parameters themselves and design entirely new policies if necessary. At the same time, it allows for the

independent performance of simulations without excessive reliance on outside help and with the minimum assistance of IT experts. Moreover, in order to ensure sustainability and long-term application, the EUROMOD provides its users with the opportunity to continuously update the model and add new data on taxes and benefits.

The development of the SRMOD allows also for the increase in scientific papers and primary research focussing on fiscal economy, public sector economy, labour economics, social policy, inequality and poverty. Work on the application of the SRMOD will help create a specific economic academic-research community, which will be closely linked to researchers in the European Union. Further presentations of the SRMOD's possibilities and results will aim at informing politicians, the press and civil society representatives, and through them, the public at large, of the necessity of conducting a socially responsible tax policy focussing on fighting poverty and advocating social inclusion.

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⁴ One of the proposals was already tested in a paper by Žarković-Rakić and Randelović (2010).

SPOTLIGHT ON:

Mapping Serbia's Growth*

*Lazar Šestović***

Big cities are becoming even bigger and these have been and will be the key drivers of economic growth in Serbia. Belgrade, Novi Sad, Niš and Kragujevac, Serbia's four largest cities contributed to about 60 percent of the increase of value added in the economy over the period 2001–2008. These four largest cities in 2008 accounted for about two thirds of country's economy. Spatial characteristics of foreign direct investments inflow, privatization process and location of export oriented sectors, indicate significant concentration. FDI and privatization were attracted by largest cities, though the proximity to the key transit routes, like Corridor 10, is also important for making decision where to invest. Export is concentrated in several places, depending on the type of production, and proximity of major export markets contributed to concentration of export near the borders of the EU (i.e., Hungary) and Bosnia and Herzegovina, the second most important export market for Serbia. Spatially uneven growth caused differences in living standards. Wages did not play significant role, as migrations did in adjusting differences in economic development among regions. Living standards are lowest in southern Serbia which has on average negative growth rates over this period and where both unemployment and poverty are highest. The last section of the report discusses some of the possible options for policy makers as response to spatially biased growth.

1. The context: Motivation for this Paper

1.a. The key findings of the 2009 World Development Report

The World Development Report (WDR) 2009: Reshaping Economic Geography argues that growing cities, migration, and trade have been the main catalysts of progress in the developed world over the past two centuries. Namely, analysis of the growth within most developed countries from North America, Western Europe, and Northeast Asia shows that growing cities, ever more mobile people, and increasingly specialized products are integral to development. The fastest growing countries were those which promoted transformations along the three dimensions of economic geography: 1. higher densities, as seen in the growth of cities and concentration of economic activity; 2. shorter distances, as workers and businesses migrate closer to density which then represents concentration of factors of production; and 3. fewer divisions, as countries reduce economic barriers to trade and transport and enter world markets thereby taking advantage of scale and specialization. These changes are also noticeable in fastest growing emerging markets economies of East and South Asia and Eastern Europe. The WDR concludes that such transformations will remain essential for economic success in other parts of the developing world and should be encouraged by government policies.

Therefore WDR's main message is that economic growth may necessarily be geographically uneven. To try to spread economic activity evenly across the country is to discourage it. But development can still be inclusive, in that even people who start their lives far away from economic opportunity can benefit from the growing concentration of wealth in a few other places or regions within the country. In fact, this should be one of the governments priorities – how to ensure participation in growth benefits to all of its citizens.

The best way to get both the benefits of uneven growth and inclusive development is through economic integration of leading and lagging regions. This should be the key challenge for the policy makers: how to integrate all the regions

* This Paper has been prepared by Lazar Šestović with significant input from Somik Lall, Senior Economist, FEU, and support with data collection, analysis and presentation from Vladan Božanić (consultant).

** Economist, World Bank.