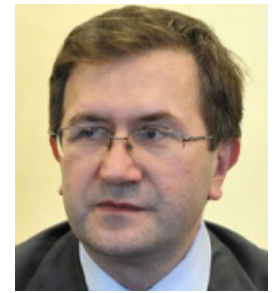

From the Editor



For the first time since 2008, Serbia has achieved a solid growth in economy, which is in fact widely spread over economic activities and is mostly generated in preferred manner- in investments and export. Serbia's economy growth in 2016 will amount to 2.5-3%, which is at a level of the expected average for the countries of Central and Eastern Europe of 2.7%. Although the growth of Serbian economy will be the highest in this year since the beginning of the crisis, it still reaches only a half of the average growth rate from the period of 2001-2008, and at the same time it is significantly lower than the growth some European countries such as Romania or Slovakia will achieve. High growth rates over an extended period of time are necessary in order to achieve a significant, and at the same time sustainable growth of the standard of living. As the average GDP growth of 6% in the period of 2001-2008 increased the average salary from 100 to almost 400 euros, thus the growth of 4-5% annually in the long term is essential for the future to significantly increase the standard of living. High growth rates are a must for Serbia to make up for a historic backlog over the next few decades and catch up with the developed European countries. However, unlike the pre-crisis period, when the growth was mostly generated by domestic demand, which led to high external and internal imbalances, sustainable economic growth in the future should be based primarily on investments and export, while domestic demand should increase more slowly than GDP.

The fact that Serbia is still in the process of reaching moderate growth rates and the Government representatives are announcing high growth rates in the coming years raises important question- whether and to what extent have the conditions for the long-term and sustainable growth of the Serbian economy been fulfilled? It is quite indisputable that in past years a significant progress was achieved in a number of areas that are important for the economic growth, but it is also quite certain that the situation in many areas is still unsatisfactory. A significant progress in strengthening macroeconomic stability has been achieved: inflation is low and stable, fiscal and external deficit have been significantly reduced, while public and external debt crisis risks have been eliminated for now. However, macroeconomic stability is still fragile and there are risks for the deficit to increase again due to the problems in part of non-privatized and non-restructured companies. Deficit could increase even if there is an excessive increase in spending or reduction in taxes. Although year 2000

achieved significant progress in establishing functioning market economy, the situation in many areas is still not favorable for economic growth. The judiciary and administration are inefficient, corruption is high, infrastructure is in poor condition, and quality of education is low and maladjusted to the economy needs... Therefore, it can be concluded that to achieve a long-term sustainable growth we need a number of reforms, as well as the insistence on fiscal consolidation. In the case of Serbia, the stimulus may come primarily from public investments into infrastructure and private investments into capacities intended for export. The growth of domestic current spending stimulates the economy growth, only under the condition that it is not excessive in relation to domestic demand.

The latest statistical information suggest to what extent the economic trends in Serbia are still unstable. After a high growth rate in the first quarter, the growth in industrial production and exports slowed down in Q2 and July, and the external deficit increased. It is therefore estimated that along with the reforms aiming to improve the economic ambient, there is also a need for a short-term stimulus to accelerate the economic growth.

Despite widespread doubts that existed in domestic professional and general public two years ago concerning the fact whether fiscal consolidation will achieve any kind of success, the results so far exceed the expectations of even the biggest optimists. Fiscal deficit in this year, even after the takeover and settlement of some emergent obligations, such as Petrohemija's obligations to Nis, will amount to about 2% of GDP. The deficit in this year will be lesser by more than 2/3 of the deficit achieved in 2014. While Serbia had a highest fiscal deficit in Europe in 2014, this year its deficit will be at the level of the average of EU member states. The stop of a growth of public debt in relation to GDP already in this year will be the result of a significant drop of a fiscal deficit. The results of fiscal consolidation are yet more favorable if one takes into account that the economy in the first year of fiscal consolidation achieved a modest growth, and that in this year it will reach a solid growth rate.

Although the austerity measures made key contribution to fiscal consolidation, the contribution of the improved tax collection becomes increasingly important. Tax revenues stagnated in real terms last year, while in this year it will increase by about 7% in real terms, which significantly exceeds the GDP growth and consumption. The growth

of tax revenues, above the growth of tax base, can be partly explained by the increase in tax rates (introduction of the excise duty on electricity), while markedly highest contribution came from combating the gray economy. The effect of suppression of the gray economy on tax collection existed even in the last year, but it was overshadowed by the fall in tax bases, especially consumption. It is estimated that on the basis of the gray economy suppression, tax revenues in the last year increased by 0.5% of GDP, and in this year on the same basis by over 1% of GDP. Based on this, it can be concluded that the gray economy in Serbia is at the moment at the historically lowest level, but a more detailed analysis suggests that the level of tax collection from 2012 is still not reached! This result is a consequence of the fact that there was a significant growth of the gray economy from late 2012 to mid-2014, which was one of the causes of the growth in fiscal deficit in that period.

A relevant question is therefore which are the causes of an increase in gray economy from late 2012 until mid-2014? Did gray economy increased due to an increase in tax rates, deterioration in the economy or reduced Tax Administration efficiency in their work? The impact of the increased tax rates on gray economy growth can quite likely be rejected as the tax collection has been increasing for two years at the same tax rates. Similarly, the growth in gray economy cannot be explained by the poor economy state as the growth in tax collection started in the mid-2014, immediately after the floods, when Serbia was in recession. Therefore, the reduction in efficiency in tax collection can be identified as the most likely cause of the growth in gray economy from late 2012 to mid 2014.

What happened during the aforementioned period with Tax Administration so the tax collection declined as much? During that period there was a reduction in Tax Administration work efficiency on several grounds, such as the shift of an experienced personnel and setting of the new ones without sufficient competence. A large number of managing positions remained vacant for a longer period of time, as the old directors were replaced, and the new ones had not been set yet, which led to a slowdown and blockade in decision-making. In addition, directors and tax inspectors obeyed the statements of the Government representatives and Tax Administration management, in which they were told that they need to rely on voluntary tax payments, wait for the introduction of modern cash registers, rather than to implement legal measures for tax collection and etc. From the mid-2014 the elimination of some major disruptions in the work of Tax Administration has been started- some personnel problems have been solved, punitive policy has been sharpened, enforced collection of claims has been implemented more resolutely, a number of inspectors participating in field control has been increased, some tax procedures have been simplified etc.

The experience with the collapse of Tax Administration and then with its recovery can serve to pull out more general lessons about the economic and political system in

Serbia. This experience shows the weakness of institutions in Serbia, how easily they give up law enforcement, the irresponsible leading of the personnel policy within them, as well as the strength of informal (illegal) impact on their work. Similar phenomena are present in other institutions, such as such as the judiciary, public administration, local government and others, but the consequences are less general there than in the case of Tax Administration. The growth of fiscal deficit and the risk of debt crisis prompted the government to implement harsh austerity measures, but also to improve the work of Tax Administration. Although Tax Administration in Serbia is still far from well-organized administrations that exist in developed countries, it was sufficient to implement some partial measures to significantly improve tax collection. If the systematic measures, such as improving of staff selection, establishing a modern organizational structure, additional simplification in tax procedures, better staff training, more efficient anti-corruption policy, more efficient cooperation with other governmental agencies and other, were implemented, the results would have been better. Even in the case of other institutions, the implementation of important partial measures could lead to a significant improvement in relatively short term, while the implementation of systematic measures would give even better and longer lasting results.

Labor Force Survey again contains information on the re-employment trends that are inconsistent with the movement of economic activity and tax revenues. According to the Survey, total employment in the second quarter grew by 6.7% or 174 thousand compared to the same period last year. At the same time the growth of formal employment is 2.7%, which is higher than data shown by the Central Registry (growth 0.1%), as well as the growth that would be expected on the basis of developments in economic activity and tax revenues, but the difference is still moving in the limits of statistical error. However, the growth of informal employment is as high as 23% (!?), which is in great discrepancy with the movement of economic activity and consumption. Additional doubt about the accuracy of data on the movement of non-formal, and hence total employment, is caused by the data from the Survey that most of the increase in informal employment was recorded in the agricultural sector and that it is 83 thousand or even 26% !? The total growth of formal and informal employment in agriculture amounted to 106 thousand (up 20%), which is not in accordance with the growth of total agricultural production, nor can it be explained by the changes in the structure of agricultural production or production technology. Finally, if one would believe in such strong employment growth in the overall economy, especially in agriculture, it would result in a large drop in productivity, which is unlikely. Therefore, we suggest that the published data on employment trends in the second quarter are checked in detail and adjusted to credibly maintain labor market trends.

