

HIGHLIGHTS

Highlight 1. Solving problems or delay and dilution

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1. Key problems and challenges

Government will face big challenges in the economy: a) a fiscal deficit in Serbia has been for two years the largest among the Central and Eastern Europe countries, and this will probably be the case in this year, b) the public sector is oversized and inefficient c) functional system of market economy has not been established. The economy of Serbia in the late 2013 and at the beginning of 2014 faces slowing growth and high unemployment, so it is necessary, alongside fiscal consolidation and reforms, for some antirecession stimulants to be implemented. Most problems the new government will face are rather old, but they increased in the previous year and so the maneuver space to further postpone their solving is exhausted².

Reasons for postponing the solution of economic problems are numerous, but probably the most important obstacle was the existence of heterogeneous governments which were not able to reach the agreement about the necessary reforms. Measures on which members of the ruling coalition reached the agreement were not sufficient to solve the problems, and problems grew over time. In the case of fiscal consolidation some parties have blocked the savings measures on salaries and pensions, other savings on subsidies, and that meant that there was no sufficient savings on positions that are the most oversized in relation to the possibilities of the country. The problem of heterogeneity will probably not exist in the new government, and the implementation of reforms will essentially depend on the determination and the ability of the dominant party (SNS) to implement them. Whether SNS will implement the decisive reforms, as announced, or choose a strategy of delay and dilution will be clear just a few months after the formation of the new government.

Fiscal deficit in Serbia in 2012 and 2013³ was over 6% of GDP, which is at the same time the largest fiscal deficit

in the Central and Eastern Europe countries, while the fiscal deficit of 7,1% of GDP is planned for 2014, with the possibility of being even larger (see details in Section 6). A direct consequence of a high fiscal deficit is the growth of the public debt in the past two years for 5.6 billion euros, i.e. increase of its share in GDP from 46.9 % at the end of 2011 to 63.5 % at the end of 2013. If a fiscal deficit of around 7.5% of GDP is achieved in this year the public debt at the end of 2014 would reach 23-24 billion of euros, i.e. it would be close to 70 % of GDP. As a consequence of a growing public debt, but also rising interest rates, interest expenditures increased from 0.8% of GDP in the pre-crisis 2008 to 2.5 % of GDP in 2013, in order to reach 3 % of GDP in this year. It is evident that these tendencies are not sustainable and that their continuation could, in the short term, lead to self-generated growth of the public debt, i.e. state could increasingly borrow just to pay its interest expenditures. In such circumstances, a crisis of public debt is highly possible, and its postponement with help of bilateral loans, which are motivated by non-market (probably internationally - political) reasons, has a limited duration. Therefore, a sharp fiscal consolidation, which would decrease the fiscal deficit to 2.5 - 3 % of GDP in the next three years, is urgent task of the new government.

Second priority of the Serbian government, which is important both for successful fiscal consolidation and for creation of a good economic environment, should be the improvement of the efficiency of the public sector. The efficiency of the public sector in Serbia is generally low, but the problems are especially concentrated in the functioning of the judiciary, land registry and town planning, i.e. the state institutions that are responsible for solving property and contractual relations in the economy. The quality of services of the state administration is low, which is manifested in low capacity for creation and implementation of economic and other public policies. The negative selection, the party hiring, and nepotism have become a widespread practice. Large space for the improvement of state performance exists in the field of education, where the state is acting as a regulator, financier and provider. Long-term economic and social development of Serbia is not feasible without raising the quality of education at all levels, from elementary school to doctoral studies. In the area of health care Serbia has made some progress over the last decade, but it is necessary to improve the availability and quality of health services in the following period, with existing relatively modest funds. There is a high degree of ineffi-

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² For more details see the Quarterly Monitor No. 28, which was released shortly after the elections of 2012, and before the formation of the government.

³ According to the official data the fiscal deficit in 2013 amounted to 5.7% of GDP, but the lags in settling the obligations of the state of around 0.5% of GDP are created, which is why it is necessary to correct the fiscal deficit to 6.2% of GDP. This correction is justified even though the budget accounting in Serbia is based on the principle of cash flow, because in a developed market economy it is unthinkable that the state is late in settling its obligations.

ciency in the performance of some public enterprises, which is manifested through high costs and low quality of their services.

Third priority of the Serbian government is the reform of the economy, i.e. improvement of the economic environment. The Serbia's economic system in many aspects significantly differs from the characteristics of a well regulated market economy, which increases costs and risks of doing business in Serbia. Some of the major differences are: financial indiscipline, predatory regulations and corruption (building permits, some elements of the Labor law, high tolerance for gray economy), excessive distortive state intervention in the economy, frequent and unpredictable changes in regulations, underdeveloped protection of competition, etc. The consequences of inadequate economic system are low investments, high unemployment, but also government expenditures for covering the losses in companies and banks, high tax debts and gray economy.

The lack of financial discipline, i.e. hard budget constraint, is probably the biggest deviation from the principles of the market economy. Financial indiscipline means that there are many market participants (companies, government institutions, etc.) in Serbia which do not settle their obligations in contractual and statutory deadlines. In the absence of financial discipline mechanisms of market selection don't work, so the survival in the market is possible for participants which are insolvent for years, some even for decades. Losses which occur in insolvent enterprises are transferred through market transactions to other market participants: banks, other enterprises, state and employees, and this leads to the spread of illiquidity and insolvency, and then to a decrease in economic activity.⁴

2. Fiscal consolidation: necessity, dynamic, content

Although most economists in Serbia estimate that fiscal consolidation is necessary, there are still economists who argue that it is not necessary, or that it is of a secondary importance compared to other policies and reforms. Representatives of the idea that fiscal consolidation is not necessary often refer to the practice of the developed countries of Europe and the U.S. that allegedly gave up on fiscal consolidation. However, data on trends of fiscal deficit in Serbia, European countries and the United States suggest that the reality was quite different.⁵ The developed members of the EU and the U.S. have reduced the fiscal deficit in the period between 2009 and 2013, on average, from 6.8% of GDP to 4.1% of GDP, and in 2014 plan to reduce the fiscal de-

ficit to 3.1% of GDP. Similarly, the countries of Central and Eastern Europe have reduced the fiscal deficit from 6.8% of GDP in 2009 to 3.8% of GDP in 2013. Even the United States, a country that is commonly cited as an example of an expansionary fiscal policy, in the current crisis reduced the fiscal deficit from 11.5% of GDP in 2009 to 6.2% 2013.

Contrary to the developments in the EU and the U.S. fiscal deficit in Serbia in the period of crisis, viewed as a percentage of GDP, was growing. In the first two years of crisis, the fiscal deficit in Serbia amounted to around 4.5% of GDP, and reached over 6% of GDP in 2012 and 2013. All countries that have had high fiscal deficits in 2013, including Greece, the United States and Britain, plan to reduce it in 2014. The only exception is Serbia, which is planning to increase the fiscal deficit in 2014, so the projected fiscal deficit of Serbia in 2014 is the largest among 29 countries observed. An unequivocal conclusion from the previous follows: the stand that Serbia conducts the policy of austerity, while other countries are giving up on austerity, stimulating consumption and increasing their fiscal deficits, is simply not true.

Other critics of implementing fiscal consolidation in Serbia state theoretical arguments, according to which reduction of consumption leads toward even bigger fall of GDP, consequently tax revenues fall even faster, fiscal deficit increases and the share of public debt in GDP increases. Based on this theoretical and empirical research follows that this sequence of events is possible, but it is unlikely that it will last for a long time (Berti et al, 2013). Reducing government spending will lead to an increase in the fiscal deficit to GDP ratio only if the fiscal multipliers are very high and/or if investors do not believe in a certain persistence of the Government in the implementation of the fiscal consolidation. The critical value of the multiplier, after which the state savings would affect the growth of deficit in Serbia is around 1, while empirical studies suggest that the consumption multipliers in countries such as Serbia are considerably smaller (Petrović et al, 2014).

A second reason government savings could affect the increase in the fiscal deficit and growth of public debt share to GDP is the distrust of investors in the persistence of the government in the implementation of fiscal consolidation. In this case the government savings can affect the reduction of private investments, because investors believe that the government will soon give up on savings, and that after that the country will enter the debt crisis. Empirical research show that even if investors do not initially believe a government, that it is enough for one to two years of consistent fiscal consolidation to pass in order to gain trust. In this period, while the

⁴ Udovički, K. (2014)

⁵ Data on movements of fiscal deficit in the countries of EU and SAD can be found on the website of the Eurostat.

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trust is not gained, GDP may decline, the fiscal deficit and public debt may grow, but that is a necessary price that must be paid for prior history of inconsistencies in the implementation of fiscal policy. Thus, although it is possible that savings measures could lead to a temporary fall in GDP, and the deterioration of the fiscal position of the country, their use is necessary because the lack of savings would lead to continuing rapid growth of public debt, and that would be a sure way to a debt crisis.

Although a fiscal consolidation is necessary, in circumstances in which Serbia currently stands (fiscal deficit of 7.5% of GDP, public debt of about 65% of GDP), questions are raised about the dynamics of its implementation and the way it should be implemented? Given the level of the fiscal deficit and the public debt, as well as the former failures in their reduction, we estimate that for the credibility of fiscal consolidation it is important in the first step to take measures which would reduce fiscal deficit in 2014 by at least 1% of GDP⁶. As the additional measures of fiscal consolidation will probably be implemented in a half a year period, these savings are equivalent to annual savings of 2% of GDP, which means that these are very strong fiscal consolidation measures. It is important for the adopted measures to be permanent, not short term, because this would allow the transfer of its effects on the following years.

Parallel with these savings it is necessary to adopt plans, in the form of law, which would ensure additional permanent savings of about 1% of GDP a year, in the period between 2015 and 2017. As a result of these savings, fiscal deficit would decline from a level of about 7.5% in 2014 to about 3% in 2017. Although this represents a very significant reduction in the fiscal deficit, it ensures that Serbia in 2017 finds itself in a fiscal position in which the CIE countries are, in average, in 2014.

An important question with regard to fiscal consolidation is in what way is it possible to reduce fiscal deficit? Reduction of fiscal deficit is possible through reduction of expenditures (savings), increase in taxes or combination of these measures. Given that the public spending amounts to about 45% of GDP, which is high for a country at the level of development as Serbia, it is necessary that the largest part of fiscal consolidation is achieved through reduction of expenditures, i.e. through savings. Reduction of expenditures of about 5 percentage points of GDP in the following three years is possible only if significant savings on the biggest expenditure positions are realized, and these are salaries and pensions. These two expenditure positions are oversized in relation to

the economic possibilities of the country - Serbia for pensions spends over 13% of GDP, while other countries at similar levels of development spend around 10% of GDP. Similarly, in the case of wages Serbia spends about 2% of GDP more than the countries on a similar level of development.

The savings on salaries and pensions will probably have to be implemented in a two steps process. In the first step nominal reduction of salaries and pensions during 2014 will be necessary, not lower than 10 %. Reducing salaries and pensions by 10 % would result in savings of just under 2 % of GDP annually, which represents 40% of needed savings in these two positions. If the reduction of pensions is illegal, or if it is politically unacceptable, then an alternate measure, which is often applied in the world, could be implemented and that is taxing pensions. If pensions would be taxed in the same manner as wages that would bring the country additional income/expense decrease of about 0.6% of GDP. However, if neither reduction nor taxation of pensions are realized that would require that the public sector wages fall for about 25%. We estimate that such a reduction of wages would not be socially acceptable, and also it would be dissimulative for the functioning of the public sector - would lead to a further deterioration in the expertise of employees, reduction of efforts, encourage petty corruption, etc.

Second step towards savings on salaries and pensions would start with the adoption of legal changes in 2014, and continue with their implementation in the following years. In the case of pensions, legal changes would encompass introduction of actuary penalties for each year of pensioning before standard age limit, increment of age limit for pensioning of women and increasing of age limit for pensioning of both men and women. These reforms would not bring great savings in the first few years of their implementation, but their effect would gradually accumulate, and so they would give significant effects in a 10 year period. Additional savings on labor costs in the public sector can be achieved by rationalizing the number of employees. In the next few years, the number of employees in the public sector, which is financed with fiscal revenues, could be reduced by 5-10%, and in doing so not jeopardize the quality and accessibility of government services (health, education, justice, security, etc.). Reducing the number of employees in the public sector needs to be systematic, which means that the smaller part is achieved through natural outflow (retirement, leaving the public sector), and the larger part by laying off workers who are working on non-productive workplaces. The savings on salaries and pensions are not sufficient to place state expenditures on a sustainable path and create additional

⁶ Reduction in relation to the previous year is difficult, as through the lags part of the expenditures is transferred from the last in this year (see the section on the fiscal policy).

space for growth of investments within the reduced expenditures.

Additional savings which can be realized in the short term relate to the reduction of costs arising from the coverage of losses of enterprises and banks, and the reduction of subsidies for investment and employment. Besides, some savings can be achieved through reform of state administration at central and local level, as well as the reform of public services (health, education, social protection, etc.), about which we write in the third point of this Highlight.

In the course of the past two years the state has had high expenses to cover the losses of some enterprises, primarily Srbijagas, as well as expenditures for the recapitalization of banks that later went bankrupt and the payment of the insured (but also other) deposits from banks in bankruptcy. Behind the losses of Srbijagas⁷, lay mostly: a) long-term sales of gas at prices lower than its cost, b) the sale of gas to insolvent companies, such as Petrohemija, Azotara, Železara Smederevo, companies in restructuring, etc., c) tolerance towards nonpayment of gas by public institutions and citizens, etc. A problem of poor management lies behind the bankruptcy of several local banks, which includes party involvement in bank management, but also the growing problem of illiquidity and probably insolvency of large private enterprises. Therefore, the reduction in government expenditures on the basis of covering losses in enterprises and banks can be solved only by the reform of the economic system, which is the topic of the third point of this Highlight.

Until the middle of 2013 Serbia was approving very extensive programs of direct and indirect subsidies for encouraging investments and employment, while in the second half of 2013 Serbia fully suspended approval of new subsidies for these purposes. However, during the election campaign representatives of the largest party (SNS) have announced extensive subsidies for investments and employment, which would be approved in a time-limited period of two years. We estimate that instead of returning to the extensive subsidies, the adequate thing, in 2014, would be to reduce these subsidies in relation to the amounts that were granted by the middle of 2013, as well as to legally determine the trajectory of their additional reduction in order to be fully repealed by the end of 2015.

Subsidies would be further reduced by limiting purposes for which these subsidies are granted - they could be obtained only for large scale investments, which have

positive effects for the economy of a region or the entire country. In addition to budgetary subsidies, it is necessary to reduce the tax exemptions and deductions, which are granted through income tax, because the income tax is still low compared to other countries.

Box 1. How European countries reduced fiscal deficits in the period of crisis – lessons for Serbia

Given that the majority of European countries, both developed and developing countries, managed to significantly reduce the fiscal deficit in the period of crisis, in the process of drafting the program of fiscal consolidation in Serbia it is useful to have in mind the way in which deficits in other countries were reduced. The study Kichert et al (2013) shows an overview of the measures that have been applied in 13 European countries in order to reduce the fiscal deficit. Almost all analyzed countries have taken significant measures to reduce labor costs, although labor costs in these countries, in relation to GDP, were lower than in Serbia. In as many as 11 countries hiring was frozen and measures to reduce the number of employees in the public sector had been taken. Salaries have been reduced in six countries, while in 11 countries they have been frozen. Almost all countries have proceeded with the reform of the public sector (health, education, pension system, administration) with the aim to reduce government expenditures. In as many as 11 countries excise duties were increased, VAT was increased in nine countries, income tax in nine countries, and the tax on profit in five countries. Tax cuts have been rare and used in developed countries that had good fiscal position, and in which tax rates are very high (Belgium, Denmark).

The experience of European countries in reducing the fiscal deficit is important particularly in the case of Serbia, because our country meets very strange and unrealistic proposals to reduce the fiscal deficit, which as a rule do not require any renouncement. According to some of these proposals the key measure to reduce the fiscal deficit is to reduce interest costs by replacement of expensive loans with the cheap ones. In the previous issue of QM we wrote about how relatively modest savings could be achieved this way, even in the hypothetical case in which Serbia would get favorable loan in the amount of three billion euros from the UAE. In the present circumstances when the contract was signed on the loan of one billion euros it is practically not possible to achieve savings by preterm return of one part of expensive loans. If the state would use this loan to repay part of the expensive loans, it would not achieve any savings because in few months, the state would again borrow at interest rates of 6-7%.

⁷ Although, there were irrational operations in Srbijagas they are of secondary importance in terms of the balance sheet and in comparison to the above mentioned causes of the losses.

An alternative proposal implies that the fiscal deficit should be reduced in relation to GDP without saving, that is, through expansionary policy of expenditures or through reducing the taxes on labor, encouraging the strong GDP growth that would lead to an increase in tax revenues, which would further result in a reduction of the fiscal deficit relative to GDP. Such dynamics of fiscal and macroeconomic variables is generally very unlikely, and in circumstances Serbia is it is practically impossible. Furthermore, it could be argued that Serbia in the last two and a half years carried out the moderate variant of this policy, and its result was the growth of the fiscal deficit and a stagnation of the economy.

From the foregoing it follows that successful fiscal consolidation in Serbia, as in other countries, have to rely on very specific saving measures: such as reducing of expenditures for salaries and pensions, reform of state-owned enterprises, reform of health care, education, etc. Furthermore, due to the delays in implementation of austerity measures Serbia will have to implement tougher measures than most other European countries.

Fiscal deficit may be partly reduced by improving tax collection, which implies combating the shadow economy but also improving tax discipline by reducing the tax debts. In doing so it is important that additional tax revenues do not represent a replacement for the previously described measures of austerity, but rather a supplement to them. According to a detailed study⁸, the shadow economy in Serbia in 2012 amounted to around 30% of GDP, and was alongside those in Bulgaria and Romania the largest in Europe. There are numerous indications that the extent of the shadow economy in 2013 was further increased. Along with the growth of the shadow economy, in 2013 tax debts were intensively growing, which occurs in situations where the tax payers register their obligations but are unable to pay them. The growth of tax debts, with a growth percentage of non-performing loans, represents a strong deterioration in financial performance in the large number of companies in Serbia, including some large private companies.

For repressing the shadow economy it is crucial to reduce government tolerance towards it, while for the reduction of tax debts it necessary to establish a financial discipline. It is estimated that Serbia within 2-3 years could reduce the shadow economy to the level of the countries of Central Europe, which would increase tax revenue for about 1% of GDP. When it comes to the tax debts collection, it is quite uncertain to what extent the chargeable tax debts occurred in large private companies over the past few years, but we estimate that the re-

venue will be lower if the solving of problems is delayed. The possibility to collect the old tax debts which largely relate to the companies in the process of restructuring is practically negligible.

3. Public sector reforms and improvement of the economic environment

The main objective of the reform of the public sector is improving its efficiency and this may be done by reducing costs and/or increasing the quality and the range of its services. Reducing the cost of the public sector is important for the success of the fiscal consolidation, and this, apart from the above mentioned measures (reduction of salaries and pensions, downsizing and parametric pension reform) should encompass reforms to reduce the costs of goods and services in the sectors of major consumers (local and the national administration, the judiciary, health, education, social services, etc.). In certain sectors improving cost efficiency can be achieved by changing the funding method - in the case of primary and secondary schools funding would be based on the number of students in the municipality, not on the number of employees. Reducing the cost of the public sector can be achieved through the rigorous prioritization of investment projects, which would postpone some projects, while permanently reject others. Prioritization would for example imply that the construction of Morava corridor, highway Novi Sad – Sabac, or the highway towards the Romanian border is postponed until the end of construction of Corridors 10 and 11. In addition, it is necessary to establish mechanisms for the cost efficiency control of investment projects.

Improvement of the quality of services of the public sector is equally important as reduction of its costs. Public sector reform is of key importance for improvement of the economic environment because without efficient judiciary and administrative services, quality education services, etc., economic and social development is not possible. It is therefore important for all major areas (administration, judiciary, education, health care, local communities, etc.) to define criteria for measurement of the quality of services, target dynamics to improve the quality and responsibility of authorities and individuals for achieving the defined goals. Improving the quality of services requires the introduction of the system of financial rewards and penalties for government institutions, depending on the results of work (primary and secondary schools). In the case of universities it would be justified for government funding to depend on the quality of the University, which is measured according to standard international criteria. In the area of doctoral studies modest resources available to the government could be concentrated in a way that from every scientific

⁸ Krstić et al. (2013)

field doctoral studies are organized at one university in Serbia, but that these studies are at the top international level (see Highlights 2). In this case improved efficiency would be two-fold, because society would receive better education with less money spent.

Reduction of public expenditures on the basis of covering the losses and financing the credits of public companies requires implementation of numerous measures starting from improvement of the management of these companies, reduction of unnecessary costs which are a consequence of the excess employment, elimination of suspicious agreements with private companies which are owned by people close to the ruling parties, liberation of public companies from quasi fiscal obligations such as all kinds of sponsorships, etc. In order to improve the revenues of public companies it is necessary for public companies to be liberated from the social function, and this implies: to form the prices for their products in accordance with the market principles, to prevent the usage of services to customers who do not pay them regularly, regardless of whether they are companies, government institutions or citizens. The example of NIS, after privatization, is a confirmation of how much the operations of a company can be improved by abolishing unnecessary costs and improving revenue collection⁹.

The overall goal of the public sector reform is creation of favorable conditions for investment and employment in Serbia and the way to achieve this is through reduction of expenditures and risks of doing business in Serbia. Reform of the economy is important also for fiscal consolidation as it would directly affect the reduction of expenditures, such as the expenditures for covering the losses of public companies and banks, and the expenditures for subsidies used to compensate for the weak economic system. Reforms of the economy would also favorably influence public revenues as the tax capacity of the economy would increase through the growing employment, consumption, etc., and the collection of taxes would also be improved (reduction of the shadow economy and tax debts).

Establishing a financial discipline, i.e. hard budget constraint, represents the most important reform in harmonizing the economic system of Serbia with the principles of the market economy. A key role in this process has the adoption of adequate bankruptcy laws that would encourage creditors and owners of companies to promptly take measures to solve the financial problems in companies, including bankruptcy procedure. Adequate bankruptcy legislation should in future

put to an end the accumulation of financial problems in companies, which is then transferred to the banks and the state. To establish financial discipline it is important to, within a reasonable time period which should not be longer than one year, definitely resolve the status of all companies in restructuring, either through privatization or bankruptcy. Establishing financial discipline requires removing the social functions from public companies, which we have previously discussed. In order to establish financial discipline it is essential that the government regularly settles its legal and contractual obligations and to drastically reduce the tolerance of the shadow economy and the accumulation of tax debts.

Improvement of the economic environment requires, besides fiscal discipline, realization of numerous other reforms, such as abolition of unnecessary and simplification of other regulations, labor market reform, ending of the privatization process, improvement of the competition policies, reduction of the shadow economy, and other. Overly complicated, unclear and mutually inconsistent regulations introduce risks, increase operating costs and represent a powerful source of corruption. It is therefore necessary to re-start the “guillotine of regulations”, which was quickly abandoned after the initial momentum. Guillotine of regulations should be a continuous process because the tendency of the state to make unnecessary and complicated regulations is fairly stable. Among the many regulations that hinder business operations for many years, complicated, costly and time-consuming procedures for the construction of buildings stand out. Thus, the legislative simplification of these procedures and the introduction of mechanisms for their effective implementation should represent one of the priorities of the new government.

Tax system reform, which would reduce the fiscal burden on labor (primarily contributions) and increase fiscal burden on consumption, would be stimulating for investments and employment, and indirectly would improve the international competitiveness of the Serbian economy. However, it is estimated that the tax system reform should be postponed until the most important problems in public finances in Serbia are solved, and these are high fiscal deficit and growing public debt.

Besides solving the accumulated fiscal and structural problems there are strong reasons to re-examine whether the current monetary policy regime is optimal for Serbia (Šoškić, 2014). Due to the fact that for a long time it is not certain whether in Serbia the benefits or costs of an independent central bank are higher, introducing currency council is a legitimate alternative that should be seriously considered. In this sense, it would be desirable that the Government conducts consultations

⁹ Improvement in NIS operations is also a result of relatively high investments Gazprom realized after taking the control over the company, and not only as a result of eliminating unnecessary costs and better collection.

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with the IMF, the ECB and the leading world economists in this field.

4. *Antirecession stimulants and sectorial policies*

While the realization of the fiscal consolidation and reforms is necessary, justification for implementing antirecession stimulants is not entirely certain, especially having in mind that in Serbia it is not possible to apply standard stimulants which are applied in market economies. While it is possible to put forward many arguments against anti-recession stimulants, it is estimated that arguments in support of their application are prevailing.

Standard stimulants refer to the reduction of the key policy rates of the central banks, which encourage commercial banks to lower their interest rates which affects increase in credit activity and then increase in investments, consumption and economic activity. In Serbia such policy cannot be implemented because high euroization prevents impact of NBS interest rate reduction on interest rates of commercial banks, consequently preventing the impact on their credit activity. Instead, the interest rates have more effect on the exchange rate and the demand for foreign currency, and so their reduction encourages the demand for foreign currency and depreciation of the dinar. Therefore, the NBS is forced to implement the policy of high interest rates even in the conditions of falling lending activity, recession and low inflation.

However, problem of a substantial drop in the level of bank lending activities, increase of the percentage of non-performing loans and the consequential decline in economic activity cannot be ignored. It is therefore justified to encourage bank lending in a different way, if this is not possible by lowering interest rates of NBS. One of the relatively efficient ways to stimulate bank lending activity during the crisis in Serbia was a program of subsidized interest rates on bank loans. Through the implementation of this program, states with relatively low resources (4-5 billion of dinars) encouraged an increase in bank lending activity for several dozens of billions of dinars. Therefore, we estimate that it would be justified for the government to continue with a program of granting subsidized loans in 2014 and the following year. Parallel with the extension of the program of subsidized loans, the government would implement reforms to systematically tackled the problem of illiquidity and insolvency of companies (bankruptcy law, etc.), which would increase the number of creditworthy companies.

In the part on fiscal consolidation, arguments are given against total abandoning of subsidies for investments and employment, but also against the continuation with

generous subsidies in the following two years. Instead of this, we propose granting lower subsidies which would gradually reduce with the aim to be completely abandoned by the end of 2015.

Besides general subsidies which would refer to all economic activities we estimate that in some sectors special sectorial subsidies are justified. In this part we lay down possible subsidies for construction and agriculture, although sectorial incentives are possible even for some other activities.

The main goal of subsidies in construction is to mitigate dramatic fall in this sector (see 2. Economic Activity) and related sectors. The second goal is to provide solution for housing problem of members of the middle class, through encouraging construction of apartments at prices that are affordable to families with average income, and this is income of family members in the interval from 80 to 100,000 dinars per month. The program would be implemented in such a way that local communities would provide free land for housing construction, and so the price of apartments would consist of two components, costs of construction of apartments and minimum cost of arranging of the construction land. Apartments built under these conditions would cost about 500-600 euros per m² outside Belgrade, i.e. 600-800 euro per m² in Belgrade. Funds to finance the construction would be granted by commercial banks, which would credit the customers and these loans would be secured by the National Mortgage Insurance Corporation.

The cost of the state for the realization of this project would consist of two components: the value of the ceded construction land and insurance costs of housing loans. Ceded construction land represents a capital transfer, which would be a cost of local communities on whose territory apartments would be built, while insurance costs would be borne by the Republic. Economic motivation of local communities to join this project is the increase in employment, income and consumption in their territory during the period of construction of apartments and the realization of future tax revenues arising from property tax. The project would be launched in Belgrade and several major cities in Serbia which during the previous decade achieved a certain economic progress, so that they have enough households that could buy apartments under these conditions. Given that the whole project would have a social component, certain restrictions would be placed in order to provide a buying advantage to families that do not have a solved housing problem.

In contrast to construction industry, where subsidies are under antirecession, incentives for agriculture would be systemic, and would aim to increase the productivity of

agricultural production, growth of exports of agricultural products, etc. Incentives would partly be aimed at individual farm households and would refer to the education of producers, approving of co-financed subsidies for the purchase of agricultural machinery, procurement of more productive plants and breeds of animals, hail protection, irrigation, etc. In all cases the state would provide a smaller amount of funds while the greater part of the funds would be provided by farmers.

Second type of subsidies would refer to the support of modern cooperative production as already exists in European countries. The state would, in this case through subsidies, participate with a certain percentage in the construction of cooperative facilities, such as cold storages, warehouses, modern machinery, etc.

In addition to subsidies the state would also apply other measures for improving the productivity of agricultural production, particularly important are incentives for the enlargement of agricultural properties. Introducing tax on agricultural land in 2014 would be one such measure, which should increase the cost of unused agricultural land, and thus to encourage the sale of smaller properties that are not used or are used unproductively. For the enlargement of agricultural properties, especially south of the Sava and Danube rivers, it is necessary to solve the unregulated property relations that now prevent the purchase transaction.

Next to fundamental questions which appear always when incentives are applied and subsidies granted, and those are the questions which refer to economic justification and fairness, another important question is how to secure the funds for antirecession and sectorial incentives in the conditions when it is needed to reduce the expenditures of the state drastically? Also, it is relevant that the total state expenditures for all forms of the above mentioned incentives (subsidizing interest on loans, subsidizing housing loans, subsidies for new employment, and subsidies for agriculture) could not be larger than 0.5% of GDP, which means it would amount to between 15 and 20 billion dinars annually. For 2014 financial resources would be secured through redirection of funds intended for the guarantee fund and a joint venture fund. As it is clear that the process of layoffs in companies in restructuring will extend on the next year, funds intended for severance pay in this year would be refocused on simulative measures.

To ensure the fiscal sustainability the total stimulation funds for specified purposes in the future would not exceed 0.5% of GDP, but their structure would change significantly over time. While subsidies for interest would be one of the biggest incentives in this and the next year this sort of incentive would be completely abolished in a 2-3 year period. Also, subsidies for job creation would be reduced so that they are completely abolished by the end of 2015. Subsidies for housing credits in 2014 would be very low but would probably grow in the next 2-3 years and after that period would decline. Subsidies for improving agricultural production would gradually grow and they would be applied in a longer period. Abolishing antirecession measures would create space for startup grants for activities that generate positive external effects, such as the development and introduction of innovations and similar activities.

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