HIGHLIGHTS

Highlight 1. Economic policy and reforms – a trade-off between rapid and carefully planned reforms

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Beginning of the world economic crisis caused more rapid deterioration in the financial health of enterprises, banks and the state. Most sectors of economy are still in recession (see Chapter 2), and financial health is deteriorating – illiquidity, closely related with insolvency, goes up. Financial health of banks is failing because real value of loans is going down, and the percentage of bad loans is rising (se Chapter 7). Drop in real value of loans to enterprises weakens their liquidity and worsens recession. Foreign exchange gains on large foreign currency loans give a false impression of recovery in their business performance[1], just like the upwards trend in production in several companies and agricultural production back on the average level create an illusion that Serbian economy came out of recession. Unemployment stagnates at very high 25%, and a half of the young population is jobless.

This year's fiscal deficit is projected at 5.5-6% of GDP (or more than 7% according to IMF methodology), the first largest fiscal deficit in Central and East European states. During the previous 12 months public debt went up more rapidly, by EUR 3.6 billion, or by 23%. Recovery in Serbian economy is modest and limited to the rapid growth in exports, reduction in the current account deficit and low inflation. Serbia's economic policy received negative evaluation from the IMF and Serbia slipped down the ranks of global competitiveness according to the report published by the World Economic Forum, which confirms that the negative trends in Serbian economy still prevail.

The government must get to grips with the growing problems determinately to prevent the country go bankrupt, slow down recession, curb the rise in bad loans etc. However, during the previous years, including 2013, they failed to do that. Stronger measures were taken only when the country was on the brink of bankruptcy, but soon after the danger would pass they were abandoned. This summer Deputy Prime Minister Vučić spoke about sweeping, radical reforms, but no further steps in that direction were made. Implementation of rapid and drastic reforms in economic system and public sector, after the Government reconstruction, was announced. However, a question as to is it reasonable to adopt fundamental reforms in a short term, without previous expert and public debate arises.

With complicated political structure of the Government, rapid adoption of major reforms could be a way to outmaneuver the opponents of reforms, and the wider public, often not willing to accept reforms. However, adoption of insufficiently planned reforms cannot be justified with high macroeconomic risks and unfavorable political environment. Implementation of such reforms can cause serious damage and compromise the idea of reforms. There are many examples of hasty adoption of insufficiently planned reforms and policies in Serbia, starting from National Investment Plan, over extraordinary increase in pensions at the beginning of the crisis, judicial reform, to fiscal decentralization. To avoid this, all reforms affecting long-term economic development should be open to an in-depth expert and public discussion, and consulted on with the IMF, World Bank and EU.

Accordingly, a line should be drawn between the policy and reforms intended to slow down recession and prevent public debt crisis, which therefore must be adopted urgently, and the policies and reforms that affect long-term economic development and therefore should be carefully planned rather than rapid. The first refers to anti-recession measures designed to enhance liquidity, stop the rise in bad loans and provide for reduction in fiscal deficit. The second refers to pension or tax reform, public administration reform, reforms in education and healthcare system, measures intended to tighten financial discipline etc. Selective approach to reforms is possible, meaning that the reforms that have already been carefully planned reforms (pension system reforms, strategies for enterprises undergoing restructuring, Labor Law reform, issuance of construction permits) would be implemented in the short-term, and insufficiently planned reforms (reform in public administration, tax reform, social security reform etc.) would be postponed.

As written in the previous issues of QM, effects of anti-recession measures in Serbia are modest due to low fiscal multipliers and inefficient monetary policy under a dual-currency system. However, this does not imply that anti-recession measures should be abandoned altogether, and that the state should take no measures against the drop in credit activity, liquidity weakening and fall in economic activity in most sectors of economy.

1 Foreign exchange gains are especially big in public enterprises, which, as a rule, have large foreign currency loans.

On the contrary, the Government should take measures against the negative trends in Serbian economy rapidly, by as early as the end of the year.

Extension of the program of state-subsidized loans has proved effective, because credit activity increased considerably through small government subsidies (subsidies worth several billion dinars brought in an increase in credit activity of several hundred billion euros), and increased credit activity leads to increase in economic activity with a certain lag. Funds for state-subsidized loans would be provided through reallocation of the budget expenditures, so the total amount of expenditures would remain unchanged. Another way to enhance liquidity of Serbian economy is to encourage small and medium-sized enterprises take loans at international financial organizations. Both measures are intended to reduce the drop in credit ability which pushes most sectors of economy in deeper recession.

Increase in government investments, which reached its lowest level of only 1.8% of GDP in the first seven months, could act as a stimulus to economic activity. Since the loans for the construction of the corridor 10 and 11 and many other projects have been arranged, there is no practical reason for the slowdown in government investments. Inefficient management of large infrastructure projects has been the major obstacle to increase in government investment. Additionally, if the government settled its outstanding debt to companies, some anti-recession effects would be achieved, but on the other hand, it would reveal that the actual fiscal deficit assessed on the basis of cash flows is higher than the official data shows.

Adoption of a credible 2014 Budget, with fiscal deficit projected at 2-2.5% of GDP below this year's, is another problem that requires speedy solution. Next year's deficit is targeted at 4% of GDP, which is acceptable only if the projection was based on international methodology, which recognizes all expenses as budget expenditures. If the projection was based on domestic methodology, which does not recognize some expenses as budget expenditures, the targeted reduction is insufficient.

The measures that have been adopted so far and the measures that (probably) have been agreed on in the Government provide for a half of the necessary reduction in fiscal deficit. This year the Fiscal Council proposed introduction of solidarity tax, as a means of indirect reduction in public sector wages and pensions that are above the average, that would provide for a large portion of the necessary savings. However, the Government, before the reconstruction, flatly rejected this proposal without offering any alternative plan for fiscal deficit reduction. The reconstructed Government must therefore come up with an alternative plan or accept the Fiscal Council's proposal. Because the 2013 Budget fell short of projections, the next year's Budget plans should be as realistic as possible, otherwise Serbian budget plans will not be taken seriously in the future. Accordingly, over-optimistic expectations about savings through implementation of the Law on Public Procurement or reduction in shadow economy should be pointed out. Best practice used in developed countries (Germany, Great Britain etc.) shows that the government should establish an institutional framework for macroeconomic forecasting (on which budget projections are based) - this year's budget revenues fell short of the plan partly due to deviation of some economic variables from the values on which the projections were based. One of the possible solutions could be mandatory harmonization of macroeconomic forecasts issued by relevant government bodies (the Ministry of Finance, Fiscal Council and National Bank of Serbia), on which Ministry of Finance's projections would be based.

Alongside with short-term measures intended to slow down recession and prevent the bankruptcy of many companies and the state, a package of reforms aimed at establishing an efficient system of market economy and improving public sector efficiency is needed. One of the key economic reforms is financial discipline tightening, meaning that all market participants must meet their liabilities within the legal and contractual terms. This is closely related to other reforms such as abolition of legal protection of companies undergoing restructuring, enhancing efficiency of bankruptcy proceedings, abolition of extensive social welfare function of public companies and public utility companies, harmonization of state aid policy with EU standards, intended to prevent some companies get preferential treatment (the case of Simpo). Tax discipline is a part of a wider financial discipline and cannot be enforced unless payment discipline among private entities is strong.

Other economic reforms necessary for enhancing business environment and investment climate are liberalization of labor regulations, regulatory guillotine, shorter construction permit issuance period etc. Most of these reforms have been discussed over years, some have been formally adopted, but the process of their implementation is very slow. Reasons behind this are many, from lack of political consensus in the ruling coalition (labor market reform), to obstruction on reforms by interest groups and bureaucracy (regulatory guillotine, building permits etc.). Implementation of these reforms is neither administratively complex nor expensive, but it would lead to loss of different rents, and the ratings of political parties that build their position on providing short-term employee benefits could fall.

Expensive loans and limited availability of loans to companies are among the greatest problems Serbian economy is faced with. By this criterion, Serbia is among the countries at the bottom of the world rankings. Reduction in interest rates on loans requires reduction in business risks in Serbia, but also dissolution of insolvent companies. Reduction in interest rates on loans requires reduction in reserve requirement ratio, which will be possible only under more relaxed monetary policy. Terms of financing in the sector of small enterprises and entrepreneurs are especially unfavorable. Legal framework for setting up micro-finance organizations, through which financial sources would be more easily available to small enterprises and entrepreneurs, should therefore be established. Small enterprises and entrepreneurs, lacking access to bank loans, would thus be able to borrow under more favorable conditions.

Serbian business environment could be improved through tax reform aimed at creating more favorable employment and investment climate. If tax burden on labor was lightened and tax burden on consumption (VAT) increased, employment rate would go up and international competitiveness of Serbian economy would improve. Tax reform through which tax burden on labor would be shifted onto capital would produce negative effects on investments, and the goal behind the reduction in labor tax is to attract investments and thus stimulate economic growth and rise in employment. Many empirical studies show that high capital taxes have severe impact on economic growth. High capital taxes lead to lower investments, and consequently to slower long-term growth, and this effect becomes more detectible with increase in international mobility of capital.

High property taxes are desirable from the aspect of economic growth, but they are difficult to collect, especially in Serbia with large portion of unused or inefficiently used property (agricultural land). Similarly, taxation on residential property is limited due to a weak correlation between the owner's income and the value of the property. Property taxes can to a certain extant direct taxpayers adjust the value and the structure of their property to their current income, but must not lead to massive confiscations. High taxation on property of legal entities are not desirable from the aspect of international competitiveness because they are built-in in the price of exported goods – high taxation on agricultural land would increase the price of agricultural products, so if a part of tax burden was shifted from labor onto property, fiscal devaluation would not be achieved.

If the aim behind high taxation on capital and non-labor income is to increase tax burden on the rich, there is no guarantee that this would be achieved. It is quite unlikely that the whole burden of high taxation on capital and property would fall on the owners. The owners would more probably try to shift a part of the burden onto employees and consumers by changing wage policy and prices of their products, in which case distributive goals behind the increase in tax on capital would not be achieved. However, if the owners failed to do that, they would transfer abroad at least a part of their business operations. Similarly, owners of commercial property would probably increase rents and thus in the long run shift a part of tax burden onto tenants – usually citizens or entrepreneurs with lower income.

Tax reforms should therefore be carefully planned, rather than rapid. Carefully planned tax reform should be at least revenue neutral, and under large fiscal deficit a revenue-producing tax reform is desirable. From the aspect of economic growth, heavy tax burden on labor should be shifted onto consumption and to a smaller extant onto property, instead of shifting it from one factor of production (labor) onto another (capital) already carrying tax burden. Predictable and stable business environment is one of the key indicators of an efficient economic system – it is therefore not advisable to sharply increase tax rates. Besides, final result of tax reforms should be a simpler and cheaper tax system. Implementation of a complex tax system, with conditional tax relieves, is expensive and suitable for tax fraud and corruption. Workable tax system must make a good trade-off between efficiency and equity, and in a country trying to speed up its economic growth, advantage should be given to efficiency.

Government must reform public sector to reduce public expenditures, and achieve budget balance in the following few years. Another important goal behind these reforms is more efficient public sector, i.e. delivery of better and more available service. Reforms in public sector should comprise pension system, healthcare system, system of education and public administration (including judicial system). Besides, to improve public sector efficiency, and to establish fair market competition, it is necessary to develop a new government subsidy policy harmonized with EU state aid standards. Reforms in pension system are critical to public finance consolidation in Serbia[1], and the key measures are offered in the studies made by the Fiscal Council, IMF and individual researchers. These reforms should be implemented rapidly, otherwise problems will continue to pile up and soon it will be difficult to handle them. While pension

1 Pension insurance reform which comprises raise in the retirement age, introduction of actuarially fair penalty and similar, is carried out in almost all European countries. Lack of political consensus on pension system reform is one of the key reasons for the public finance crisis in Slovenia. Given the health of Serbian public finance, further delay in pension system reforms would produce more serious effects.

system reforms are aimed at reduction in expenditures, the main goal behind the reforms in healthcare system, education system and public administration is better efficiency. This means that better quality of these services is as important as reduction in expenditures.

It is still unclear to what extant is the government willing to carry out the reforms. Government structure remained almost unchanged after the reconstruction, so it is uncertain whether it will be possible to implement pension system reforms, change the Labor Law, improve efficiency of the bankruptcy proceedings, cut budget expenditures etc. Regarding system of education, it is uncertain whether the primary school network rationalization plan will be implemented, whether accreditation requirements for higher education institutions and programs will be tightened, or whether labor market will be liberalized to increase the quality of doctoral studies. Political parties that blocked these reforms and opposed the arrangement with IMF are still in the Government.

Highlight 2. Financial performance of companies owned by the Republic of Serbia

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There is no doubt that state-owned enterprises, regardless of whether they are legally organized as public sector companies or joint stock companies, play an important role in the economic life of the Republic of Serbia. Those companies usually carry out activities of common interest, such as production, transmission and distribution of electricity; production and processing of coal; research, production, processing, transportation and distribution of oil and natural and liquid gas; railway, postal and air traffic; telecommunications; utilization, management and protection of the property of the public interest (such as water, roads, minerals, forests, etc.); production, marketing and transportation of arms and military equipment, and so on.[1]Many of these activities have a strategic importance for the development of the Serbian economy. Also, we have to mention the results of some studies indicating that public sector companies hired, on average, 10.7% of total employed workers, engaged even 17.7% of total assets and had 29.3% of the owners' equity in the domestic economy in the period from 2006 to 2011.[2]Despite all the above, a system of regular and comprehensive monitoring and control of their performance is still not established, although we are witnessing the fact that the significant resources, that they use, are being spent irrationally and inefficiently. The most valuable information about the state of public sector companies, their problems, and possible solutions to these problems are contained in the studies of international financial institutions, consulting companies and individual researchers. However, these in-depth and, by nature, one-off analyses cannot be a substitute for regular monitoring of the operations of these companies. The aim of this analysis is to examine the financial position and profitability of the key state-owned enterprises in an integral and comprehensive manner, which could result in useful guidelines for improving their performance in the future, both for their management and policy makers.

Basic financial information on the companies included in the analysis is given in Table 1. These are state-owned companies whose functioning is under the jurisdiction of the Republic. Local public enterprises were not the subjects of this analysis. It should be noted right at the beginning that these ten enterprises in 2012 recorded a cumulative net loss of 69.5 billion RSD. Only four of companies earned profits and two companies lost the entire owners' equity through previous operations and generated losses above their equity.

Without going further into the explanation of individual results we will briefly mention that the basis for assessing the performance of selected public sector companies and other state-owned enterprises were cumulative financial statements obtained by adding up the positions of separate and consolidated financial statements of these companies.[3]These are presented in Tables 2 and 3. For the purpose of assessing liquidity, solvency and profitability of these companies, standard financial analysis techniqueswere used: ratio analysis combined with an analysis of net working capital (NWC) and cash flows.[4]

1 See: Law on Public Companies,"Official Gazette of the Republic of Serbia", no. 119/2012.

2 Malinic, D. "Financial power (weakness) of public sector companies", Proceedings: Accounting regulatory environment: stimulus or restriction for economic growth, 44th Symposium of Accounting and Corporate Finance in modern business environment, Zlatibor, 2013, p. 131-154.

3 Separate and consolidated financial statements of companies included in the analysis were taken from the website of the Serbian Business Registers Agency.

4 For more see: Malinic, D., Milicevic, V., Stevanovic, N. (2012) *Management Accounting*, The Publishing Centre of the Faculty of Economics in Belgrade, p. 83-188, White, GI, Sondhi, AC, Fried, D. (2003) *The Analysis and Use of Financial Statements*, John Wiley & Sons, Inc., P. 110-163.