

HIGHLIGHTS

Highlights 1: Fiscal Consolidation, Monetary Policy and Reform

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The most important move of the Government in the area of economics, from its formation to beginning of 2013, was the adoption of the fiscal consolidation programme. The fiscal consolidation programme and 2013 budget temporarily removed the imminent danger of public debt crisis, but not permanently. Consolidation programme is accompanied by a series of additional measures, whose aim is improvement of conditions of doing business (abolishing of quasi-fiscal levies) and putting order into public finances in Serbia (inclusion of own revenue in the budget, etc.). NBS continued to increase the restrictiveness of monetary policy, even though inflation has been low since November, while the economy, with the exception of a few industries, is in recession. Restrictive monetary policy encourages the strengthening of dinar, which slows down the reduction of current account deficit and creates potential problems in case of reduced foreign capital inflow. Among other things, this raises a question of whether it is justified to make decisions on monetary policy based on the trends in year-on-year inflation or if it is necessary, when making a decision on monetary policy, to take into account the trend of inflation in the last few months, as well as the expected trend of inflation. After the initial acceleration, the economic system and public sector reforms have been relatively quickly pushed to the background. Instead of systematic reforms, the Government again started with the implementation of selective and discriminatory measures, such as conditional write-off of interests on tax debts, and it also announced the policy of selective reduction of taxes. Government activities in attracting foreign investments are desirable, but they cannot serve as replacement for implementation of reforms or as an excuse for implementing measures that violate the rules of fair market competition.

1. First results of fiscal consolidation programme

Government's fiscal consolidation programme foresees a reduction of fiscal deficit from 6.6% of GDP in 2012 to 3.6% of GDP in 2013. It is planned that approximately half of the reduction in deficit should be realised through tax increase, while the other half would be realised through savings. In terms of tax increase, the most significant contribution is expected from VAT, which

should yield an increase in public revenue of 0.7% of GDP, next from corporate income tax (0.6% of GDP), excise duties (0.2% of GDP), and personal income tax (0.2% of GDP). The largest savings are planned in pensions (0.8% of GDP), salaries (0.6% of GDP) and spending on goods and services (0.6% of GDP).

During the adoption of the consolidation programme and 2013 Budget¹ it was estimated that some expenditures have been underestimated (spending on goods and services), and that there are risks of incurring certain unplanned expenditures (Smederevo Steel Works). That is why at the end of last year, we estimated that despite the macroeconomic forecasts (GDP growth of 1.5-2%, 7% inflation, unchanged exchange rate in real terms), the fiscal deficit would be around 4% of GDP, i.e. around 155 billion dinar instead of the planned 132 billion dinar.

Republic budget deficit in the first two months of 2013 was around 25 billion dinar, and it is estimated that the consolidated government deficit in the first two months was lower, i.e. around 25-30 billion dinar. According to some preliminary estimates based on the first two months, it can be concluded that the trend of consolidated deficit is far above the level planned by the Government (instead of the planned 132 bn dinar, the deficit will be around 170 bn dinar). Since the fiscal deficit will be considerably higher than the officially adopted deficit (by over 1 p.p. of GDP), the fiscal trends in the first months of 2013 can by no means be considered positive. Possible faster growth of economy by 1.5% would not have a significant impact on the reduction of fiscal deficit, because the main factors of growth are industries that do not bring high taxes – export of cars and oil derivatives, as well as the growth of agricultural production. That is why it is necessary, in line with the Fiscal Council recommendations, to quarterly monitor budget execution and, if necessary, adopt additional measures so the fiscal deficit would not exceed 4% of GDP. It is especially worrying that Republic budget deficit in the first two months was as high as 28% of the planned annual deficit and that it was significantly above the usual seasonal dynamic. High Republic budget deficit in the first two months additionally confirms there is an imbalance between the revenue and obligations on different state levels, where the most important one is the vertical imbalance created by the co-called fiscal decentralisation.

¹ See Arsić (2012), "Fiscal Consolidation and Recovery of Serbian Economy", Quarterly Monitor no. 30 or Fiscal Council documents published during Q4 2012.

Fiscal consolidation measures on the revenue side were enforced in October 2012, while fiscal consolidation on the spending side did not begin before 2013. That is why now, after four months of implementation, it is possible to give a preliminary estimate of the effects of tax increase. In the analysis we will focus on the effects of VAT and excise duties increase, because they were already supposed to yield results. The effects of corporate and personal income taxes increase will show in the coming months, so they will be analysed in the coming issues of Quarterly Monitor.

At the beginning of October, the standard VAT rate was increased from 18% to 20%, while the lower rate of VAT remained unchanged. In addition to the increase of VAT rate, a series of other measures was adopted as well (raising the limit for entering into VAT system, increase of VAT rate that is subtracted at the buy-out of agricultural products, limited VAT exemption on baby products, etc.), which will result in reduced revenue from VAT. It has been estimated that VAT revenue in 2013, as well as the net results of stated measures, should increase by about 0.7% of GDP. At the same time, some economists and business people have estimated that increase of VAT will result in reduction of VAT revenue instead of its increase. Whether or not the stated increase in VAT revenue will be realised will significantly affect the realisation of the planned reduction of 2013 fiscal deficit.

In order to evaluate the effects of VAT increase on revenue, it is necessary to observe the share of VAT revenue in GDP, because this way, the effects of recession on revenue are excluded. Share of VAT revenue in GDP in the fourth quarter of 2012 was higher by 0.4 p.p. than the average share in the same quarter in the previous four years, while compared to the same quarter last year, the share in GDP was increased by 0.5 p.p. (see the last line of Table 1). Thus, it can be concluded that the increase of VAT rate led to an increase in revenue, but that the effect was somewhat smaller than expected. Still, a more reliable estimate of effects of VAT rate increase will be possible after the data for the first half of 2013 become available, because in parallel to the increase of VAT rate, a series of other changes have been realised, which affected the temporary reduction in VAT revenue (transfer of a portion of taxpayers from monthly to quarterly payments, shortening the time for tax returns, payment upon realisation, limited exemption for baby products, etc.). These changes in the VAT system have certainly lowered the level of revenue in the first months of the change, but this will be offset by higher revenue in the following months.

According to the fiscal consolidation programme, excise duties revenue in 2013 is foreseen to grow by 0.2% of GDP. Excise duties revenue in the fourth quarter of the previous year was by 0.2% of GDP higher than the average share in the fourth quarter of previous four years. However, excise revenue in the fourth quarter of last year was lower by around 0.5 p.p. of GDP than in the same quarter of the previous year (see the last line in Table 1). Generally speaking, the trend of excise duties revenue during previous years expressed a high variability during the year, which cannot be attributed to seasonal factors. Even though it is hard to make a reliable estimate based on the data from last few months on whether or not the planned excise duties revenue will be realised, there are indications that it will be lower than planned by several billion dinars.

Table 1. Share of most important public revenues in GDP, in %

| | Public revenue | Income tax | Tax on profit | VAT | Excise duties | Customs duties | Other tax revenues | Contributions | Non-tax revenue | Capital income |
|--------------|----------------|------------|---------------|------|---------------|----------------|--------------------|---------------|-----------------|----------------|
| 2008,Q4 | 44.1 | 5.5 | 1.2 | 11.0 | 4.3 | 2.4 | 1.3 | 12.5 | 5.8 | 0.0 |
| 2009,Q1 | 42.0 | 5.0 | 2.1 | 11.3 | 4.0 | 1.9 | 1.2 | 11.9 | 4.6 | 0.0 |
| 2009,Q2 | 39.2 | 4.9 | 0.8 | 10.0 | 4.5 | 1.7 | 1.2 | 11.7 | 4.3 | 0.1 |
| 2009,Q3 | 42.4 | 4.8 | 0.9 | 10.9 | 5.5 | 1.7 | 1.5 | 11.5 | 5.6 | 0.0 |
| 2009,Q4 | 44.8 | 4.9 | 0.9 | 11.6 | 5.7 | 1.8 | 1.6 | 11.7 | 5.8 | 0.0 |
| 2010,Q1 | 41.6 | 4.9 | 1.8 | 11.2 | 4.3 | 1.5 | 1.5 | 11.7 | 4.7 | 0.0 |
| 2010,Q2 | 40.9 | 4.8 | 0.9 | 10.8 | 4.9 | 1.5 | 1.7 | 11.1 | 5.1 | 0.0 |
| 2010,Q3 | 41.1 | 4.6 | 0.9 | 11.1 | 5.7 | 1.5 | 1.5 | 10.6 | 5.3 | 0.0 |
| 2010,Q4 | 45.9 | 5.0 | 1.0 | 11.3 | 6.1 | 1.6 | 1.7 | 11.5 | 6.8 | 0.0 |
| 2011,Q1 | 40.5 | 4.5 | 2.0 | 10.9 | 4.8 | 1.2 | 1.4 | 10.8 | 4.7 | 0.0 |
| 2011,Q2 | 38.3 | 4.7 | 0.9 | 9.9 | 4.9 | 1.2 | 1.3 | 10.5 | 4.7 | 0.0 |
| 2011,Q3 | 40.5 | 4.6 | 0.9 | 10.6 | 5.7 | 1.2 | 1.4 | 10.6 | 5.4 | 0.0 |
| 2011,Q4 | 44.7 | 5.2 | 1.0 | 11.2 | 6.0 | 1.3 | 1.4 | 11.7 | 6.2 | 0.1 |
| 2012,Q1 | 43.2 | 4.9 | 3.2 | 11.0 | 4.8 | 1.1 | 1.3 | 11.9 | 4.9 | 0.1 |
| 2012,Q2 | 41.3 | 5.0 | 1.3 | 10.9 | 4.9 | 1.1 | 1.4 | 11.5 | 4.8 | 0.2 |
| 2012,Q3 | 42.1 | 4.9 | 1.2 | 11.2 | 6.5 | 1.1 | 1.3 | 11.2 | 4.6 | 0.1 |
| 2012,Q4 | 44.9 | 5.3 | 1.2 | 11.7 | 5.8 | 1.1 | 1.2 | 11.7 | 6.1 | 0.7 |
| Average Q4* | 44.9 | 5.2 | 1.0 | 11.3 | 5.5 | 1.8 | 1.5 | 11.9 | 6.2 | 0.0 |
| Difference** | 0.0 | 0.1 | 0.2 | 0.4 | 0.2 | -0.7 | -0.3 | -0.1 | 0.0 | 0.6 |

*) Average fourth quarter before consolidation (2008-2011)

**) The difference in income in Q4 2012 and the average of the fourth quarter in the previous four years

2. Should the restrictiveness of monetary policy be reduced?

At the end of 2012, the inflation was suddenly stopped; the economy, save for a few industries, is in recession; unemployment is stagnating at a high level; external deficit is slowly decreasing, but is still high, while the foreign debt is close to 90% of GDP. In addition, as of the beginning of 2013, the fiscal consolidation programme has started, which will decrease the fiscal deficit in 2013 by around 2 p.p. of GDP. In such circumstances, NBS still increased the restrictiveness of monetary policy with an explanation that year-on-year inflation is high and that an increase in administratively controlled prices is expected. Below, we will dispute both arguments and then analyse negative consequences of restrictive monetary policy in current macroeconomic circumstances of Serbia.

As one of the main explanations for increasing restrictiveness of monetary policy, the NBS states year-on-year inflation, which is still high and whose growth

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is expected in the next month or two. However, it is questionable whether in conditions of high and variable inflation that is characterised by sudden crashes, the year-on-year inflation is the best indicator based on which decisions on monetary policy are made. Year-on-year inflation includes inflation that already happened 10 or 11 months ago and that cannot be affected by any measures, nor can the inflation from 10 or 11 months ago affect the current inflation. So we are faced with a paradox that year-on-year inflation at the end of 2012 and beginning of 2013 is still growing even though the increase of prices since November 2012 has been quite small. In countries with low inflation, this issue is irrelevant, but it is relevant in countries such as Serbia where inflation is over 10%. Maybe it was precisely the decision making on monetary policy based on the year-on-year inflation that caused the monetary policy during 2009 and the second part of 2011 to be restrictive for too long. That is why it would be more adequate to make decisions on monetary policy based on the annual equivalent of average inflation in the last few months and expected inflation in the following months.

The second argument for continuing with restrictive monetary policy is that it prevents or at least decreases the effect of increased administratively controlled prices on inflation. However, this argument can hardly be accepted, because monetary policy can only mitigate the indirect effects of the increase in administratively controlled prices. To be more precise, monetary policy can only make the buyers of products whose prices are administratively controlled (e.g. electricity) absorb part of the cost of administratively controlled prices, i.e. not to transfer them to end consumers. Scope of monetary policy in this segment is very limited due to a lot of factors, such as low level of competition, rigidity of prices, poor state of companies, etc. That is why the level of monetary restriction that would “force” the producers to absorb the cost of increased administratively controlled prices should be very high, and such a monetary policy would probably be pro-recessionary.

One of direct consequences of overly restrictive monetary policy is the strengthening of dinar exchange rate, even though the deficit in current account balance is still quite high (see the chapter on Balance of Payments). Such a policy does not cause problems on foreign currency market as long as there is a considerable inflow of capital, whose value exceeds the deficit in current account balance. In Serbia, that occurred in the second half of 2012 and at the beginning of 2013, when a high inflow of capital was realised through state borrowing on international market. However, such an inflow of capital is unsustainable in the long-term, because it leads to increased growth of foreign and public debt, so the

question arises as to what will happen on the foreign currency market once the inflow of capital is reduced. The answer to this question can be found based on the trend on foreign currency market during the first half of 2012, when high inflow of foreign capital suddenly stopped in conditions of high deficit in current account balance. The result of this imbalance was a strong depreciation of dinar and reduction of foreign currency reserves of NBS. It is important to remember that such a policy was preceded by high capital inflow, restrictive monetary policy and strengthening of dinar during 2011. The difference in relation to 2011 lies only in the fact that capital inflow back then was more the result of private investments than state borrowing, while now the inflow of capital is mostly due to state borrowing.

A lesson can be taken from the above that it would be better if NBS gradually reduced restrictiveness of monetary policy and allowed moderate depreciation of dinar that would influence a reduction of deficit in the current account balance. Reduced deficit in current account (that will be affected by other factors as well, such as growth of exports of Fiat and NIS, etc.) would make the country less vulnerable to a reduction in foreign capital inflow, that could happen for many different reasons. Reduction in restrictiveness of monetary policy in the current period would reduce the risk of sudden decrease in foreign currency reserves of NBS and sharp depreciation of dinar in the case of reduced inflow of foreign capital. The result of such a turn of events would be the sudden increase of inflation in the future, and that would require a strong increase of restrictiveness of monetary policy. Reduction of monetary policy restrictiveness would accomplish a gradual, rather than sudden, adjustment and that would decrease the variability of dinar exchange rate and inflation. Increase of fiscal policy restrictiveness, within the fiscal consolidation programme, creates additional room for lower restrictiveness of the monetary policy.

Depreciation of dinar, as a result of reduced monetary policy restrictiveness, should be moderate so as not to significantly worsen the asset position of companies, citizens and the state, who are all mainly indebted in foreign currency. In euroised economy, such as Serbia's, strong depreciation increases the cost of servicing the loan and deteriorates the relation between the loan and debtor's assets. That can lead to an increase in non-performing loans, mass bankruptcies, and eventually to a crisis in the banking sector and a recession.

3. Delay in reforms and flourishing of selective incentives

For fiscal consolidation programme to succeed, it is crucial to adopt austerity measures this year, that would contribute to a reduction of fiscal deficit by around 2% of GDP next year. In order for the austerity measures to be realised, public sector reform is necessary, whose implementation should be prepared during the first half of the current year, so that the reforms could be implemented through the 2014 budget.

Public and business sector reforms are necessary not only for the implementation of fiscal consolidation and prevention of a debt crisis, but also to create conditions for long-term sustainable growth. Effective limitations of Serbia's economic growth lie in undeveloped economic system and inefficient public sector and not on the demand side. Removing these obstacles requires large public sector and economic system reforms². Such reforms were announced in the first months of the new Government and some of them have been realised, but after that there was a delay not only in the implementation, but in the preparation of reforms as well.

One of the possible reasons for the delay in reforms is almost constant talk of the possibility of holding new parliamentary elections – such a possibility is often being announced not only by the opposition, but by ruling coalition as well. The possibility of early elections directly affects the delay in the implementation of austerity measures, which are not popular, but are necessary for the reduction of fiscal deficit and removing the risk of public debt crisis (abolishing certain subsidies, introducing actuary penalties for early retirement, extending the age limit on retirement, rationalising the network of schools, firing surplus employees in the public sector, combating shadow economy, etc.).

Political instability manifested in constant possibility of holding early elections shortens the time horizon that politicians have in mind when making decisions. That means they are opting for popular measures that yield visible, short-term results, even when long-term effects of such measures are negative. Accordingly, the Government postpones the implementation of essential reforms that usually require certain sacrifices and savings if their implementation lasts 3–4 years. Thus, it can be concluded that some of the biggest obstacles in implementing economic reforms in Serbia lie in the political system that leads to the establishment of unstable governments with a large number of coalition partners. Systemic solution of this problem is to change the elec-

tion law, which would enable consolidation of the political scene and forming of stable governments, which would consist of one or a small number of parties.

Delay of reforms for political interests of the ruling coalition is facilitated by the possibility of state borrowing on global financial market under relatively favourable conditions. In doing so, the fact that public and foreign debt of Serbia are already quite high is being ignored, as well as the risk of debt crisis, which has not been removed, but rather temporarily postponed. We should also remember that many debt crisis in the world were preceded by a period of cheap loans – at the end of 1970s, Yugoslavia borrowed in cheap petrodollars, only to get into a debt crisis at the beginning of 1980s.

Instead of systemic reforms, selective government intervention measures are again being applied, which damage the already underdeveloped market environment. Although there are a few of these measures, the analysis will focus on two: conditional write-off of interest on tax debts and announced selective reduction in income tax and social contributions in the IT sector.

Write-off of interests on tax debts is an example of a short-term measure that does not solve the fundamental problems of Serbia's economy, which is mass insolvency of market participants and financial indiscipline. The interest write-off temporarily improves the solvency of tax debtors, whose accounts are thus unblocked, and state revenue is temporarily increased due to regular payment of obligations by the debtors. However, in most cases, the problems of debtors are not solved by interest write-off, which is why the write-off is repeated every three-four years. By nominal interest write-off in conditions of high inflation that exists in Serbia, part of the real value of the principal debt is written off as well. In this way, indisciplined tax payers are being awarded and the disciplined ones punished, because they paid a bigger real tax value for the same transactions. The writing off of real value of the principle through the write-off of interest represents a gross violation of equality among market participants.

Periodic write-off of interest and part of the principle creates an expectation in taxpayers that it will happen in the future as well, which directly encourages a moral hazard – deliberate avoidance of paying tax obligations in order to have them reduced in the future reprogramming. Interest write-off for tax debts would be justified only if it would be realised as part of a wider programme of establishing financial discipline, which would have as a key measure elimination of insolvent companies from the market. Only in that case would the Government promise that there will be no interest write-off in the future be credible and would not encourage financial indiscipline.

² For more details as to which reforms the Government should implement, see Quarterly Monitor no. 30

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As part of the measures of attracting foreign investments, selective reduction of taxes for IT sector employees has been announced. Possible implementation of this measure is quite contrary to basic principles of market economy, because taxpayers (the citizens) would pay different taxes and contributions for the same wages depending on the industry they work in. Attracting investors through selective taxes is an even more damaging and unacceptable form of arbitrary government involvement in market processes than is the case with approving subsidies. If this measure were passed, it would open up doors to new requests for selective tax treatment. Even though such requests are contrary to the rules of equal market competition, they would be equally justified as in the case of IT preferential treatment. There is no economic argument that would allow information technologies to have preferential treatment in relation to, for example, bio technology, food production, clothes manufacture, automobile industry, pharmaceutical industry, etc. Instead of preferential tax treatment, the government should improve the conditions

of doing business for all sectors. As far as the IT sector is concerned, it is necessary to increase investments in higher education institutions that would train students for these professions, review the justification for opening new colleges, and enable the return of Serbian engineers from abroad.

Government involvement in attracting large foreign investments is desirable, but it cannot replace economic system reforms or justify the violation of rules of fair market competition by introducing various direct subsidies and tax reliefs. Approval of generous tax and other incentives will probably attract individual investors, but without an economic system reform, there will be no massive investments that would be arranged without Government's direct involvement. Besides, as a condition of investing in Serbia, the new potential investors will request subsidies and tax reliefs similar to those approved in the past. The result is the increased deterioration of market environment, as well as the loss of tax revenue and increase in fiscal deficit.

Highlight 2: Analysis of parametric reform of corporate income tax in Serbia

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In December 2012 a number of amendments to the Corporate Income Tax Law (the Law) were adopted. It is believed that these amendments were driven by two major goals:

- To increase the revenue impact of corporate income tax, within a broader fiscal consolidation program;
- To improve efficiency in implementation of corporate income tax regulations and enhance the business environment (through technical improvements to the law, reduced room for tax evasion and by aligning taxation rules with international best practices).

The analysis and evaluation of the reform of corporate income tax in Serbia thus must be made within the context of the foregoing goals.

1. Fiscal effects of the reform of corporate income tax

Corporate income tax revenues in Serbia make up approximately 1.3% of GDP, which is far below the average of EU 27 member states (2.4% of GDP), and

the average of Central and East European states (2% of GDP). Weaker revenue impact of corporate income tax in Serbia is the result of: *i)* lower statutory tax rate, *ii)* wide range of tax reliefs due to which Serbia has by far the lowest effective corporate income tax rate in Europe. Increase in revenue impact of corporate income tax as a goal behind the reform is therefore considered to be justified. Corporate income tax revenues in Serbia will increase chiefly through increased statutory tax rate, and to a lesser extent through abolition of some tax reliefs.

The newly adopted provisions of the Law provide for the increase in standard rate of corporate income tax from 10% to 15%, and abolition of some tax reliefs. When the rights related to the public sector are broadly defined, general taxes should not be low, because that would lead to increase in fiscal deficit and public debt. Corporate income tax rate in Serbia charged at 10%, was one of the lowest in Europe, while the public expenditures (as % of GDP) exceed the EU average and the average of the countries in the region. The adopted increase in corporate income tax rate to 15% is therefore considered justified.² Even after being increased, the corporate income tax rate in Serbia is still considerably lower than the EU average (about 25%) and corporate income tax rates in most Central and East European states (about 18%).

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² Apart from Serbia, in 2013 Slovakia increased corporate income tax rate (from 19% to 23%).