Highlight 4. Review of some of the proposed measures for recovery in Serbian economy and public finance

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Deteriorating health of Serbian economy and public finance encouraged a number of non-standard recovery proposals. In this Highlight we will analyze three such proposals that have been long present in the media, and that we find unsuitable and harmful to Serbian economy and public finance[1]. More precisely, we think that the effects of the proposal to fund economic development through base money creation can be fatal, and that the proposals to clear up the problems in public finance through government pension fund capitalization and state crackdown on shadow economy are unrealistic.

Investment advisor Nebojša Katić brought forward a proposal to employ base money creation as an instrument for solving Serbia's current economic problems and for boosting economic development. Possible implementation of this plan would be fatal to Serbian economy and citizens[2] because it would cause a sharp depreciation in the dinar, and almost immediate rise in inflation, and finally a steep drop in economic activity. Serbia has experienced this scenario several times (within SFRY and FRY), and under the present circumstances it would unfold more quickly.

The main reason why Serbian government cannot stimulate economy through monetary policy[3] is a continuous abuse of base money creation, starting from as early as 1970s up to 2001, with short breaks during the implementation of stabilization programs developed by Ante Marković and Dragoslav Avramović. This abuse resulted in a dual-currency system with about 70% of financial assets in euros, i.e. with dinar inferior to euro. Real demand for Serbian dinar is low, and even a modest increase in supply of dinars (base money creation) would increase demand for foreign currency, instead of increasing credit activity of banks. For this reason the National Bank of Serbia is unable to follow an expansionary monetary policy like other central banks do, even during recession. With low real demand for dinar, the National Bank of Serbia mostly has had no other option but to follow restrictive monetary policy during the ongoing crisis.

We remind that base money creation through loans to government made by central banks is almost abandoned - interest rates are typically used as a monetary policy instrument. In recent period, base money is created through so called quantitative easing, used only when economy is in recession, interest rates are close to zero and inflation is very low. However, only one out of the three conditions is satisfied in Serbia - economy is in recession, but interest rates and inflation are high.

Miladin Kovačević and Mahmut Bušatlija's proposal to make up the pension fund deficit by pension fund capitalization through local property also deserves attention. The deficit pension fund runs is somewhat larger than Serbia's overall fiscal deficit so its elimination would considerably improve the health of the public finance. However, two questions arise. The first one is how much property is needed and what return should it produce to make up the pension fund deficit. Let us assume that the capitalized fund would yield a return equal to the 3% average for Central and Eastern Europe, recorded before the crisis. With this rate of return, the capitalized fund would have to have property worth 67 billion euros on disposal to provide for the funds needed to make up a deficit of 2 billion euros (about 2.4 billion euros in the previous years). The foregoing value of property is several times higher than the total revenues that have been raised through privatization since 2001 (including Mobtel and the banks), and about 30 times as big as the assessed value of Telekom Srbija.

The largest portion of local property is made up of local public goods (streets, parks, sports and recreation facilities and courts etc.), natural monopolies (water supply, sewage, heating etc.) and social institutions (nursery schools). Clearly, none of these categories of property can be used to capitalize the pension fund. Possible pension fund capitalization could therefore be done through use of urban construction land or commercial space. However, this property brings in considerable tax or rental revenues to local governments, so if it was transferred into the pension fund, local government deficits would widen significantly. Consolidated deficit would remain almost unchanged – reduction in pension fund deficit would be proportionate to increase in local government deficit.

Most of the construction land and commercial space owned by local municipalities is to be privatized in the

1 Academic community and politicians mostly ignore these proposals. However, we believe they should be discussed, to avoid the impression that there are easy solutions to difficult problems but that for some reasons they are not being adopted.
2 Mr. Katić's proposals are not in accordance with the Law on the National Bank of Serbia, meaning that for now they cannot be implemented.
3 The National Bank of Serbia cannot even use interest rates, as an anti-recession instrument, in the same way as other central banks do.

future. However, revenues from local property privatization are usually used for funding local infrastructure, already in a very bad state in Serbia. If this property was transferred to the pension fund, local governments would be forced either to borrow or to increase the currently levied, or some other, taxes. In the long run, it comes down to one thing – tax increase. This would not improve Serbia's consolidated balance sheet either, unless the local taxes are increased.

This leads to conclusion that a possible transfer of local property into the government pension fund would fail to provide the funds needed to make up the pension fund deficit. Possible decrease in the pension fund deficit would cause approximately equal increase in the local government deficit. Apart from the foregoing shortcomings, the proposal to capitalize government pension fund through local property suggests that perhaps there is no need for radical reforms in the pension system or that the reforms are of secondary importance, which is completely wrong and leads to more serious problems.

The third debatable proposal is based on the estimation that state crackdown on shadow economy can drastically reduce fiscal deficit – the most ardent advocate of this idea is Milan Knežević, president of the Association of Small and Medium-sized enterprises. Serbia's shadow economy is very large (around 30% of GDP) and the government can certainly collect additional revenues through tackling it. However, a more in-depth analysis shows that in the mid-term public revenues collected through shadow economy curbing can total around 1% of GDP, which is much below Serbia's fiscal deficit (around 6% of GDP). This is based on the estimation that, for example, in a three-year period the size of Serbia's shadow economy, in the best case scenario, could be reduced to the level of the Central European states, from the current 30% to around 25% of GDP. A 5 percentage point reduction in the size of shadow economy would bring in additional public revenues of about 1.5% of GDP, but only under assumption that by stamping out shadow economy the government would not stamp out activities that go with it. However, this is quite unlikely because only some informal activities can be legalized, and the acquisition of the abandoned activities by entrepreneurs and employers operating legally is a gradual process. We therefore believe that in the mid-term additional public revenues collected through shadow economy curbing could total around 1% of GDP, rather than 1.5%. On the other hand, the ideas to eliminate fiscal deficit by halving the size of shadow economy are substantially unrealistic, because it means that the size of shadow economy should be reduced to 15% of GDP, which is much smaller than in most developed European countries or in the USA. Under inefficient institutions and poor tax morale this is estimated impossible.

Undoubtedly, shadow economy should be tackled for the purpose of establishing fair market competition and increasing public revenues. However, from the aspect of public finance, revenue impact of the reduction in the size of shadow economy must not be overestimated. Overestimated revenue impact could lead the government to abandon some austerity measures or even reduce some taxes. Under any of these scenarios, fiscal deficit reduction would slow down and the public debt growth would speed up.