HIGHLIGHTS

Highlights 1. Forecast of Economic Developments for 2012

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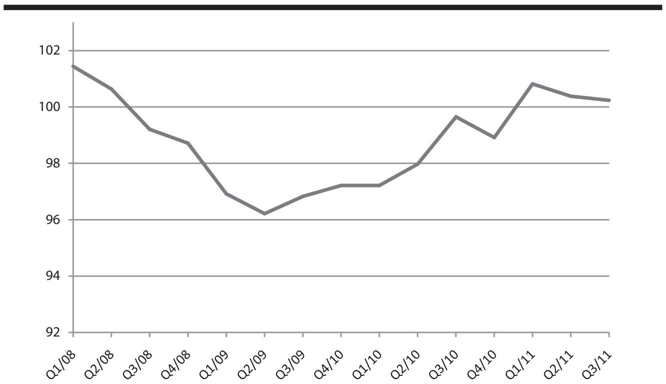
The Ministry of Finance and the International Monetary Fund (IMF) made a downward adjustment of their GDP growth projection for 2012 from 3% to 1.5% due to the prolonged stagnation of the national and European economy. The *QM* analysis shows that the growth assessment adjustment for 2012 is justified, but there are significant risks that economic growth may fall short of estimate. A further escalation of the eurozone crisis is highly likely to push the Serbian economy into a new recession. These Highlights aim to point out the different economic activity case scenarios for 2012, so that adequate economic policy options can already be reviewed now. We did not consider the option of a deeper economic crisis which, although not entirely excluded, we still believe to be the less likely option.

Economic activity developments in 2011 are best illustrated by the seasonally adjusted GDP growth indices shown on Graph 1. We note that a steep GDP growth in Q1 was followed by a mild decrease in economic activity. The intensity of the last economic downturn is still not as powerful as in the first crisis spell, but the latest indications from the eurozone, which the domestic economy is closely linked with, call for caution.

Graph 1. Seasonally adjusted GDP growth index, (2008=100)

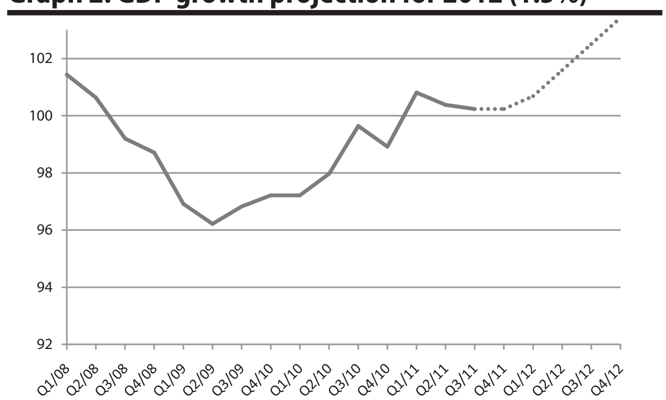


Source: *QM* based on SORS data

The course taken by GDP in 2011 (Graph 1) has yet another adverse effect – due to a gradual decrease in production, in 2012 recovery will start from the negative zone as compared to the 2011 average. Overall economic growth in 2012 will remain low even in the case of a solid economy recovery due to the decline brought forward from 2011. The estimated GDP growth rate of 1.5%, although seemingly moderate, actually entails a much stronger recovery of the economy in the ensuing year than it would be intuitively expected.

Just to illustrate how rapid economic recovery needs to be in order for the GDP to reach 1.5% in 2012 and to point out the potential risks of failing to achieve such growth, Graph 2 gives projections of the required trends of the seasonally adjusted GDP for 2012. We can see that the y-o-y GDP growth in Q1 2012 (Graph 2), will approximate zero despite the commenced recovery due to the decline brought forward from the end of 2011. The y-o-y GDP growth will then move into the positive zone almost reaching 3.7% in Q4. Total GDP growth in 2012 will be almost equal to the average y-o-y growth of all four quarters, i.e. it will amount to approximately 1.5%.

Graph 2. GDP growth projection for 2012 (1.5%)



Source: *QM* based on SORS data

Graph 2 shows the conditions that need to be met to achieve a 1.5% GDP growth in the next year. These are: (1) no drop in output in the last quarter of 2011, for which official data are still unavailable, and the seasonally adjusted GDP in Q4 remains at the same level as in Q3; (2) output recovery commences in the year 2012 and (3) the natural annual GDP growth rate[1] of 4% is reached in the second quarter of 2012 (0.9% of quarterly growth). The QM analysis indicates that all three assumptions are optimistic, but nevertheless plausible, at the same time, the risk that the growth in 2012 might fall short of planned is significant. The same analysis indicates that the possibility that GDP growth might exceed 1.5% in 2012 can be excluded with great certainty given that even the realistic growth of 1.5% will be hard to attain.

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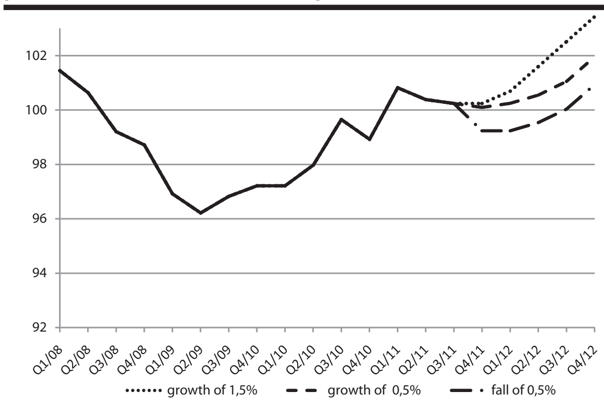
1 The natural (potential) growth rate of 4% is defined by the law (the Law on Budget System). We believe that this rate clearly reflects potential growth of economic activity in Serbia. A somewhat higher average pre-crisis growth rate of the Serbian economy of round 5% was realized as accompanied by the growing external and internal imbalance.

Taking into account that the GDP growth estimate of 1.5% in 2012 will depend on several optimistic assumptions, *QM* has also analyzed some more conservative case scenarios. Graph 3 shows varying assumptions of economic activity trends in the following period. We first assumed that achieving the potential GDP growth rate will take more time. These trends are indicated by the economic recovery curve in the first quarters after the crisis in 2009 that we almost copied to 2012. The aforementioned case scenario will result in a GDP growth of about 0.5% in 2012 (Graph 3). The following case scenario assumes that there will be a production drop in the last quarter of 2011, similarly as in the economic crisis in 2008. This case scenario is also anticipated by the most recent eurozone indicators (orders of industrial products that precede industrial production trends fell in September more than in the previous crisis spell). In this case scenario the recovery would commence in the first quarter of 2012 but from a lower level of economic activity, i.e. the decline continuing from 2011 would be even greater (Graph 3). This case scenario would result in a fall of the total GDP of about 0.5% in 2012 due to the drop in Q4 2011. The GDP growth rate would also decline to 1.7% in 2011. We have not yet considered the option of a deep recession commencing in 2012, i.e. the double bottom crisis in the shape of the letter *W*– still assessing it as quite unlikely – but not even this case scenario can be excluded with any certainty.

Graph 3.GDP growth projection for 2012 (different case scenarios)



Source: *QM* based on SORS data

The analysis of GDP *by use* provides additional insight into economic activity trends for 2012. Considering that the Statistical Office of the Republic of Serbia does not keep track of the GDP *by use* on a quarterly basis[2] unfortunately, our analysis is based on indirect indicators (aggregate salaries, pensions, construction activity, import of capital goods trends and similar). The analysis of these indicators in 2011 shows that economic growth was achieved owing to increased investments. Private and public spending experienced a real decline, whereas the contribution of net exports to GDP was moderate.[3 4]

In 2012, investments will most probably remain at the level registered in the previous year. The high real investment growth of about 10% in 2011 is not very likely to continue in 2012. Large investment projects from 2011 are close to their completion (FIAT, NIS), and borrowing funds for new investments has been made more difficult at the end of 2011 due to growing risk premiums that consequently raise interest rates charged for investment loans. In its budget plan for the next year, the state has announced relatively high real growth of public investments of about 15% in the next year, but due to the relatively low share of public investments in total investments, this will not have a decisive influence on overall trends. It should be taken into account that for several years the execution of public investment projects has been below planned figures at the beginning of the year, but there is also a possibility that the 2012 elections and waiting for the establishment of a new Government may cause a temporary standstill in the implementation of certain capital projects.

The assumptions underlying this analysis indicate that *private spending* will register a real growth of about 1% in 2012. Private spending will largely be financed from salaries and pensions. The pension bill will experience a real growth in 2012 by about 3%. The real increase in the pension bill in 2012 will be a consequence of adjusting pensions in line with inflation and half of GDP growth registered in 2011.[5] The projected rise in the number of pensioners also contributed to the projected real growth in the pension bill. The wage bill in the public sector will, according to the first projections, have a similar real growth to the pension bill and will be little above 2.5%. The larger portion of the total wage bill in Serbia, however, relates to the private sector which, due to shrinking employee headcount[6], in an optimistic case scenario, is expected to see an unchanged real wage bill

2 Here we reiterate the necessity of introduction of an official quarterly GDP use assessment, as is the practice in most European countries. The GDP assessment from another aspect would resolve numerous dilemmas regarding the movements in economic activities in Serbia.

3 For further details please refer to Section 2 "Economic Activity" of this *QM* edition.

4 It is interesting to note that such structure of economic activity growth has significant implications on fiscal policy, given that spending conducive to tax revenues are decreasing, whereas GDP components with significant tax exemptions (exports, investments) are increasing. This is why, even despite GDP growth in 2011, there has been a real drop in public revenues. The share of public revenues in GDP in 2011 decreased by as much as two percent compared to 2010 – from 41% to 39.1% of GDP.

5 On slowing the inflation, indexing pensions and wages to previous inflation, being higher than the future one, leads to their real y-o-y growth. In case of accelerated inflation, wages and pensions are depreciated faster than indexation, causing their real decline.

6 For further details refer to Section 3 "Employment and Wages" in this edition of *QM*.

level against 2011. This is why we estimate that the total real growth of the wage bill in 2012, inclusive of private and public sector alike, will range from 0.5% to 1%. Out of other, more significant sources of private spending: (our experience from the previous crisis indicates that) remittances will most probably remain at the same level, while there is room for a somewhat slower growth in consumer and cash loans than in 2011 – when their real growth approximated 6%. Taking the above into consideration, we expect a real growth of private spending in 2011 of about 1%.

Public spending will experience a real growth of about 1% in 2012, similar to the rise in private spending. Although public spending is a GDP component most reliably assessed for the following year, at this moment this is still fiction. Because, among other reasons, the plan of public allocations for goods and services in the following year is very restrictive, some savings may not be achieved and the growth of public spending may still exceed the plan.[7] On the other side, if economic growth falls short and planned tax revenues are not realized, as cautioned by the analysis provided in these Highlights (Graph 3), there will be a consequential adjustment of public expenses and public spending will fall short of planned.

Taking into consideration both options: (1) that real public spending growth should exceed the planned level and (2) that public spending should fall – we infer that it is much more likely for the real growth of public spending in 2012 to be below 1%. Public spending exceeding the planned level would be difficult to finance, given that public debt neared the statutory ceiling of 45% of GDP.[8] Potential growth of costs of goods and services *in excess of* the planned level may be achieved only within budgeted limits – most probably by decreasing public investments. Such redistribution would have a neutral impact on GDP on the short run, but on the long run, owing to larger public investment multiplication effect, the reallocation of public expenses from investments to spending would have a negative impact on economic growth.

Reaching a 1.5% GDP growth in 2012 would require a significant positive contribution of net exports to economic activity growth. We arrive to this conclusion given that the previous analysis of all other GDP components in 2012 are indicative of having a smaller real growth compared to the estimated GDP growth (1.5%). A difficult question to answer at the present moment is: will the net export contribution in the following year be sufficient to achieve a 1.5% economic activity growth?

Two criteria should be met if the required real growth of net exports is to be achieved in the next year, given the small share of exports in GDP: 1) exports should grow at least twice as fast as imports and 2) exports growth rate should be significant (at least 10%) so that it can sufficiently contribute to overall economic growth.

Data from the previous years indicate that this is feasible. Following the first crisis spell, output recovery in Serbia in 2010 was driven by exports growth. However, we are not so confident that there will be a rerun of a similar scenario in 2012. In the first place, along with the recovery of the global economy, 2010 has witnessed increased demand on the most important export markets. Now the deterioration of the crisis in the eurozone will have an adverse impact on export growth – all the more so given that crisis has particularly stricken countries such as Italy that are Serbia's most prominent trading partners. In the second place, the national economy entered 2010 with a significant increase in its price competitiveness due to the real Dinar depreciation. The situation now is that the speedy export growth is not favorably influenced by strong real Dinar appreciation in 2011, which has considerably diminished the price competitiveness of domestic products.

In the circumstances of a possible crisis escalation in the eurozone, it is difficult to reliably estimate the economic activity trends in 2012. The practice of the Statistical Office of the Republic of Serbia to frequently revise its GDP estimates for several quarters, even a year in retrospect, additionally undercuts the reliability of the estimates.[9] For instance, downward adjustments to published data on high GDP growth for Q1 2011 would lead not only to a decrease of estimates for the entire 2011, but also to an automatic reduction of the basis used for comparing economic results for the year 2012, and consequently the growth in 2012 would be higher. Our intention is not for QM to provide an alternative GDP growth estimate, given that we neither have sufficient data available nor a developed detailed methodology, or adequate institutional capacities as the Statistical Office of the Republic of Serbia, the Ministry of Finance and the National Bank of Serbia (NBS). Our aim is to spur an expert debate and show that *indicators of the economic activity trends*, with currently available data, give a rough indication that the 1.5% of GDP growth in 2012 will be hard to achieve, even if there is no additional deterioration in the economic situation.

7 For further details refer to Highlights 2: "Serbia's Fiscal Policy in Response to a New Crisis Outbreak and Prolonged Recession" in this edition of *QM*.

8 For more details refer to Section 6 "Fiscal Flows and Policy" in this edition of *QM*.

9 For more details refer to Highlights: "The Reliability of Official Gross Domestic Product Data in Serbia," *QM* 24.

Highlights 2. Serbia's Fiscal Policy in Response to a New Crisis Outbreak and Prolonged Recession

Milojko Arsić *

These Highlights analyze key elements of the fiscal policy for 2012, stipulated in the Agreement between the Serbian Government and the International Monetary Fund (IMF). A more in-depth analysis is not possible because the proposed budget and other documents defining fiscal policy for the ensuing year are still unavailable to the public in the moment of writing these Highlights. The second part of the Highlights analyzes the impact of the new crisis outbreak and a potentially prolonged recession in Europe on Serbia's fiscal position, as well as the possible responses of the fiscal policy.

1. Basic Elements of Fiscal Policy in Serbia in 2012

The agreement between the Government and the IMF sets out the basic parameters of the 2012 fiscal policy. The amount of consolidated income and expenses in 2012 and their detailed breakdown by state levels, and income and expense line items have still not been published. Therefore, this analysis will focus on the elements arising from the agreement reached with the IMF, regulations and statements made by the Government representatives. According to this agreement, the consolidated state deficit in the ensuing year will amount to 4.25% of GDP. Unlike this year, when the fiscal deficit increased by the amount fully corresponding to the fiscal provisions on anti-recession policy following the reduction of the estimated GDP growth rate, the increase in fiscal deficit is currently 0.25 percentage points lower, compared to the level prescribed by the fiscal provisions. The main reason for a smaller fiscal deficit growth is the fact that the public debt almost reached the maximum legally permissible limit of 45% GDP, as well as the estimate that this proportion will be exceeded in the following year due to a significant deceleration of GDP growth.

Next year, the statutory limit on the public debt to GDP ratio will be exceeded because the Serbian economy, like many other European economies, is facing a new crisis outbreak instead of the expected recovery, and maybe even a prolonged recession. As a consequence of a new crisis outbreak in 2011, instead of the planned 3% growth – a growth of a maximum[1] of 2% will be achieved, whereas the projected 4% growth in 2012 was first reduced to 3% and then to 1.5%, and the growth expectations for 2013 is approximately 3% instead of the earlier projected 5%. Reduction of the fiscal deficit by 0.25 percentage points of GDP in 2012 relative to the rule on anti-cyclical policy is one of a series of steps towards the sustainability of public finances. Although the decrease of fiscal deficit by 0.25 p.p. compared to the maximum set forth by the relevant fiscal provisions is relatively modest, it is an important signal to investors and others that Serbia is taking steps to reduce the deficit and contain the growth of the public debt.

Although the budgets for 2012 are still unknown, it is estimated that the share of consolidated consumption in GDP will increase in the next year by 0.3–0.4 percentage points compared to the current year. In addition, the share of the central state expenses (the budget of the Republic and social insurance funds) in GDP will decline by 0.2–0.4 percentage points, while the participation of expenses incurred by local communities in GDP will rise by nearly one percentage point of GDP. On the central state level, an increase in expenditures for pensions, wages and interest rates is expected relative to GDP, whereas expenditures for subsidies, net borrowings and purchase of goods and services will drop relative to GDP. On the local community level, the share of almost all expense components in GDP will mark an increase.

Hence, broken down by state level, fiscal adjustments in 2012 will be fully achieved on central level, while local level government revenues and spending will increase considerably. Such distribution of the burden of fiscal adjustments is a consequence of the Law on Fiscal Decentralization whereby RSD 35–40 billion was reallocated from the central level to local communities.

Expenses for wages and pensions account for over 50% of the consolidated state expenses. The trends in expenditures for wages on all state levels and pensions is determined by fiscal provisions, stipulating that the growth of salaries and pensions depends on changes in inflation and real GDP growth, as well as exogenous factors such as the increase in the number of retirees. Due to the high level brought forward from 2011[2], the anticipated slow GDP growth in 2012 and autonomous increase in the number of retirees[3], the cost of wages and pensions relative to GDP is expected to increase. In addition, the share of the interest expense in the GDP is expected to rise as well, both due to increased public debt and borrowings undertaken by the state at ever higher interest rates. The largest savings on the level of the Republic are planned for the items of subsidies, state

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1 Indicators reflecting movements on the GDP balance of expenses (personal consumption, state consumption, investments and net exports) show that in 2011 the growth ranged from 0% to 1%.

2 The real wage and pension level at the year's end is above the average for the entire year 2011.

3 In the previous years, the number of retirees grew at an annual rate of about 1.5% and this is expected to continue in the forthcoming years.

loans and goods and services purchase costs. Planned savings in the Republic's budget represent a positive step in fiscal consolidation, because expenses identified as exceptionally high in comparative analysis have been cut down, and these probably include irrational spending of public funds.

These savings in the Republic's budget have not been sufficient to adjust the consolidated balance to the limit of 4.25% GDP, so there is a plan for a one-time boost in the Republic's revenues. One-time revenues are planned based on proceeds expected from bankruptcy, dividends paid by public companies, as well as the accrual of budget beneficiaries' own funds. In addition, liabilities related to local road maintenance have been transferred from the Republic to local communities. From the technical aspect, the reallocation was achieved by raising the share of the Republic's budget in excises on oil derivatives and by reducing the participation of the Public Enterprise Roads of Serbia. The plan is to compensate Roads of Serbia for the shrinkage in excise duties revenues from the fees charged to local communities for local road maintenance services. For this reallocation to be sustainable on the long-run local communities will have to take on local road maintenance costs of approximately RSD 10 billion.[4] Additional reallocation between the Republic and local communities will be achieved by discontinuing investments in local projects by the Republic, which started already in the second half of 2011 and whose annual value amounted to RSD 6–7 billion. The accounting for these redistributions does not affect the consolidated balance, but is essentially relevant from the aspect of decreasing consolidated deficit, as they are used to reconcile income and expenses of different levels of authorities.

Based on the Decentralization Law, local communities will obtain additional funds of RSD 35–40 billion, as the net difference between the increase in revenues from payroll taxes and decrease in transfers from the Republic. By undertaking to finance local road maintenance and local projects, it is assessed that local communities will take on additional liabilities of about RSD 16–17 billion, the same amount for which the Republic's budget will be unburdened. Hence, once they have undertaken to finance additional functions, local communities will have RSD 20 billion more funds at their disposal than last year, for which they will not incur additional legal obligations. Given that wage increases have also been limited at the local tier[5], it is estimated that additional funds will be used for discretionary expenses such as public investments, settlement of arrears, purchase of goods and services, subsidies.

From the aspect of a functioning economy, prioritizing settlement of arrears towards businesses and citizens when it comes to spending additional funds of local communities is considered necessary. Settlement of arrears would have a certain anti-recession effects, which is particularly important in a situation where there is hardly any room left for anti-recession policy on the level of the Republic. Investing a portion of the additional resources in upgrading local infrastructure is justified, along with increased application of economic methods in the assessment of project implementation feasibility, as well as enhancement of project implementation efficiency. In a situation of increased expenses for purchase of goods and services and subsidies, there is a risk of irrational spending and dissipation of resources at the local tier. Hence, it seems justified for the Republic to impose an obligation on local government to prioritize settlement of arrears and local investments when spending the additional funds by the end of 2011 and in 2012. Also, it would make sense to limit the growth of subsidies and goods and services purchase costs on local level[6] to prevent irrational spending of funds and encourage local communities to improve their financial statements. However, long-term matching between revenues and spending at each government tier is an important element of fiscal consolidation and, for this reason, it is justified that local communities, once they have settled arrears, should participate in financing some additional function – for instance the take over of the liabilities from the Republic in the field of social welfare, worth approximately RSD 10 billion.

Reducing the consolidated fiscal deficit by using one-time revenues of the Republic's budget in 2012 is a temporary, to some extent imposed solution, but impossible to sustain on the long run – proceeds from bankruptcies are a one-time inflow, and collecting dividends from public companies hampers their growth and the development of their activity. Similarly, the long-term use of budget beneficiaries' own income is economically unjustified as in most cases these are various user charges (such as water charges), which should either be used for their intended purpose or alternatively decreased if they generate a permanent surplus. Hence, the reduction of fiscal deficit in the forthcoming years must be based on systematic measures. The systematic reduction of fiscal deficit in the years to follow will require significant reforms in the sectors that are the main public revenue users: pension system, health care, education, state ad-

4 It is still uncertain whether all necessary preparations for the take-over of liabilities by local communities for financing local roads will be finalized by the beginning of next year.

5 There is a risk that the number of employed at the local tier will increase thereby triggering an increase in total payroll expenses.

6 The limitation would not apply to additional expenses for local road maintenance.

ministration, as well as improvement of the public procurement system and devolution of some of the powers from central to local level. Strategies for the reform of the foregoing sectors were put together more than once during the previous decade, many of the reforms have been implemented, but much remains to be done (rationalization of the school network, reconciliation of human and physical resources in health care facilities with the changes in the territorial distribution of the demographics, improvement of the efficiency of public investment and similar). These reforms aim not only to achieve savings in the public sector, but to improve the quality of its services (education, health care, administration and similar), which is an important precondition for a successful economic and social development.

2. Impact of the New Crisis Outbreak on Serbia's Fiscal Position and Possible Responses of the Fiscal Policy

Serbia's fiscal policy is defined based on the projection that GDP growth in 2012 will amount to 1.5% to be followed by gradual growth acceleration. GDP growth projections in Serbia and their achievement depend to a large extent on economic trends in European countries – Serbia's key economic partners. Previous projections are based on the assumption that the current crisis in European countries will be short-lived and that the recovery of their economies will commence already in 2012.

Be that as it may, economic trends in EU member countries in the second half of 2011 make the prospect of their recovery almost uncertain. The escalation of public debt in most eurozone members in the second half of 2011 halted the mild recovery of European economies, some of which are on the brink of a new recession. The inability of the EU to address the public debt issue encountered by its member states and other economic issues, among which high unemployment and declining competitiveness compared to other parts of the world, has led to a reconsideration of the very foundations underpinning the eurozone and the EU itself. Ergo, it is uncertain which turn the EU and the economies of its member states will take. It is not certain whether new institutional arrangements will be adopted to enhance decision-making efficiency within the eurozone and the EU or whether the countries will regroup on a different integration level. Some of the scenarios allow for the possibility of deep and long-lasting recession in the EU or some of its member countries, Serbia's important economic partners. Some economists foresee that Europe, and maybe even the world, are facing an extended recession, as has been seen throughout economic history, including recent history, which entails interchanging periods of GDP decline, stagnation and slow recovery lasting a decade or even longer. Naturally, there is still a possibility that the new crisis outbreak will be short-lived and limited to 2011 and 2012 and followed by the recovery of the global economy instead of long-term recession.

In the event of a deeper and more lasting crisis in the EU, the Serbian economy would suffer much lower growth rates than planned. A lower than planned growth of the Serbian economy would have significant fiscal implications – a 1 percentage point decline of the GDP growth rate would trigger a drop in public revenues by about 0.4 GDP percentage points. Unless measures are taken to additionally reduce public spending, the fiscal deficit and public debt will be increased by the same amount. For instance, in case of stagnation (zero growth) in 2012 instead of the projected 1.5% GDP growth rate and in the absence of an additional cutback of expenses, the growth would amount to 4.85% of GDP, while the public debt to GDP ratio would additionally increase by approximately 0.6 percentage points.

This is why economic policy makers in Serbia, same as elsewhere in the world, ponder over the options – what type of fiscal policy should be implemented in response to a new crisis outbreak or prolonged recession. *One option* entails a cutback of the fiscal deficit to the statutory limit in order to bring the public debt below the statutory ceiling in two or three years' time, whereas the *second option* directly or indirectly entail the increase of the fiscal deficit and raising the statutory limit on the public debt to 60%. In agreement with the IMF the Government chose the first option for the year 2012, which means that the debt related provision has priority, and that the fiscal deficit is to be kept below the prescribed ceiling, in order to return the public debt within legal bounds.

Choosing the *first option* entails that fiscal deficit in the basic scenario is below the statutory limit and that in the case of a deteriorating economic situation in Europe and in Serbia, additional savings measures are taken so that the fiscal deficit to GDP ratio declines in the ensuing years and so as to impede the growth of the public debt. The policy of decreasing the fiscal deficit to GDP ratio in the ensuing years is essentially the only sustainable option for Serbia. In 2012, the 45% statutory limit on the public debt will have been exceeded, and if the policy of increasing fiscal deficit were to be pursued, which would lead to a growth of the public debt to GDP ratio in the ensuing years then the likelihood of a public debt crisis in Serbia would rapidly grow. The results of numerous empirical researches and some current examples show that the critical limit after which a country slides into a debt crisis varies from one country to another. While countries with high credit rating (such as Japan) have a public debt exceeding its GDP by 100% are still able to borrow on financial markets at favorable terms, countries with low credit rating, such as Serbia, frequently experience a debt crisis despite having a public debt of or less than 50% of its GDP.[7]

As in accordance with the low credit rating, upon the issue of Eurobonds, before the onset of a new crisis outbreak, Serbia paid a high interest rate of 7.25% annually. The aforementioned interest would now (beginning of December 2011) be even higher due to deterioration of the conditions on the international financial market, and would rise even higher owing to the increase in the public debt to GDP ratio. The growth of the public debt and debt service costs would result in an ever-growing share of public revenues being used to pay interest, which would in itself place increasing pressure on the public debt. Al the same, a major risk is that at some point of time that cannot be anticipated with certainty, investors may assess Serbia as insolvent and consequently refuse to finance its fiscal deficit and settlement of matured debts, which would trigger a debt crisis. The current public debt crisis outbreak in Europe has made investors increasingly distrustful and cautious, and they now respond by refusing to finance the public debt of some country with much lower debt to GDP ratio than was the case in the past. The existence of a short-term public debt of approximately EUR 2 billion makes Serbia very vulnerable in case investors should lose their trust. Hence, if the Government does not curb the growth of the public debt to GDP ratio in an organized manner (by reducing fiscal deficit), the market will do that for the Government, by declining to finance Serbia's public debt.

While in Europe and globally governments strive to reduce fiscal deficit, which would first slow down the public debt growth and then cause the public debt to GDP ratio to drop, in Serbia there are requests of various interest groups (employer associations, trade unions), political parties – that would lead to an increase of the fiscal deficit and accelerate the growth of the public debt. The proposals to increase fiscal deficit are usually indirect and take the form of proposals for a significant decrease of taxes or increase in spending aimed to stimulate economy. Those who are behind these proposals usually fail to mention the implications of their proposals on the growth of the deficit and public debt that would result in exceed the ceiling set by fiscal provisions, because this is not politically popular. The proposals for a cutback in taxes most frequently relate to the reduction of fiscal burden on wages, which is unquestionably high and has a negative impact on employment, economic growth and imports. However, isolated application of this measure would result in the increase of the fiscal deficit and accelerated growth of public debt, thus pushing the country into a debt crisis in which case, instead of accelerated economic growth, there would be a decline in economic activity and employment. Decreasing tax rates would lead to a drop in tax revenues that could not be possibly compensated for by increasing employment rates, improved tax collection – as it never did in the past. For instance, after reducing the tax burden on labor in 2007, the share of income tax revenues in GDP permanently decreased by 1 percentage point (i.e. from 6% to 5% of GDP), which means that the structural deficit in Serbia grew by the same amount under unchanged conditions.

Generally, empirical research conducted worldwide indicates that a decrease in tax rates invariably brings down tax revenues relative to GDP, i.e. the reductions in tax rates does not lead to such a growth in the tax basis (e.g. employment and wages) and improvement of tax collection that would compensate for the loss of income incurred as a result of the decrease in tax rates. The decrease in tax rates is generally not self-financed[8], as tax rates are by default below the level of the Laffer Curve maximum. At the same time, this implies that the reduction of tax rates inevitably leads to the increase in fiscal deficit. Therefore, proposals for a selective application of tax reforms, through the reduction of tax rates, are irresponsible as they would additionally increase fiscal deficit, accelerate public debt growth consequently increasing the likelihood of a debt crisis. The recklessness of these proposals is additionally aggravated by the fact that tax revenues in crisis times decline all the same due to reduced tax bases – income, employment and consumption. The decrease of tax rates in the crisis period is the exact opposite of the steps taken in European countries, where tax rates either increase or remain at the same level.

Instead of selective decrease of tax rates, Serbia should rather implement a comprehensive tax reform with the aim of creating a favorable environment for long-term economic growth[9], without jeopardizing macroeconomic stability. Compliance with the second requirement means that tax reforms should be neutral to income, at least in the medium term. The main course of tax reforms is the change in the structure of the tax system through

7 See Reinhart, C. and V. Reinchart (2009).

8 A decrease of tax rates may lead to an increase in fiscal revenues only in certain situations. One such situation is the decrease of tax rate on return on equity, as this is an extremely mobile production factor, so low tax rates may allure foreign capital – this effect came to pass in Serbia during the previous decade. The second situation is where excise duties on products that are relatively easy to smuggle are cut down, which were previously at a much higher level than in the surrounding countries.

9 The proposal for a tax reform recommending the reduction of the tax burden on labor and the increase of the tax burden on consumption is provided in the document written by Arsić et al. (2010)

a decrease in fiscal burden on labor and increase in fiscal burden on consumption. The accomplishment of these reforms would contribute to creating a more favorable environment for employment, investments and export, while consumption and import would become more expensive.[10] Additionally, in the course of the tax reforms, it is necessary to reexamine and probably phase out numerous income tax incentives and exemptions whose justifiability is more than questionable, given the very low tax rate of 10%. Also, tax reforms on local level should provide to increase the balance sheet value of property tax, and decrease local fees and charges "plaguing" entrepreneurs and micro businesses – that are most affected by the economic crisis and suffering from declining employment figures. Tax reforms implemented locally broadening the tax base and decreasing tax rates would contribute to improving the efficiency of this segment of the tax system. Hence, the reduction of the tax burden on labor, otherwise desirable, is sustainable only within a wider tax reform which is income neutral and that would not only reduce the tax burden on labor but also concurrently increase consumption taxes.

Proposals for increasing the fiscal deficit are negligent of compelling theoretical arguments, and moreover numerous empirical research corroborating that the anti-recession reach of fiscal incentives in countries like Serbia is rather modest.[11] Serbia is a small open economy with flexible foreign exchange rate so the value of the aggregate fiscal multiplier is considerably below 1. Exceptions include public investments whose multiplier is above 1, and beside the positive mid-term anti-recession effects, public investments into infrastructure also have a long-term positive influence on economic growth. Proposals to increase the statutory limit on public debt to 60% also pave the way for creating additional space for the increase of fiscal deficit in the ensuing years.

Taking into account relevant characteristics of Serbia, such as small open economy with flexible exchange rate and low credit rating, it is assessed that in terms of a new crisis outbreak and potentially prolonged recession, the only fiscally responsible option for Serbia is the reduction of the fiscal deficit, so that the breaking through the existing statutory public debt ceiling would be as minimal and as short-lived as possible. Minimizing the dimensions and duration of the break through the public debt ceiling requires the adoption of a reliable plan that would bring the public debt to GDP ratio back to legally permissible levels. The decrease of the high level fiscal deficit and improving the public sector efficiency are necessary conditions for long-term sustainable growth of Serbia, irrespective of the current global economic crisis and potential long-term recession. The new economic crisis outbreak only amplifies the intensity of necessary cutbacks. Moreover, in the case of a prolonged recession, more radical measures will have to be applied, on both the spending and revenues side.

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10 See for instance the European Commission (2008) and OECD (2010)

11 See in Ilzetzki, E., E.G. Mendoza and Carlos Vegh (2009) or Spilimbergo, A., S. Symansky and M. Schinlder (2009)

Highlights 2. Convergence towards Brussels: a Matter of Form and/or Substance

Jelena Žarković Rakić *

Towards the end of 2009, Serbia submitted its application for membership in the European Union (EU), and one year later it made significant steps towards formal accession to the Union: visa requirements were abolished and a decision to commence ratification of the Stabilisation and Association Agreement was adopted. Finally, last year Serbia formally received the Questionnaire that served as a basis for the European Commission's Opinion on our country's application for EU membership.

Although this brief period of time saw significant steps being made towards Serbia's formal approximation towards the European Union, the distance our country has to go in its strivings towards Brussels is still unknown, primarily considering the results of the political and economic reforms implemented in the previous decade. The Opinion of the European Commission, recently published, assesses Serbia's ability to meet the criteria set by the European Council in Copenhagen in 1993 and the requirements of the Stabilisation and Association Process. The Opinion also identifies key policy areas that will be under special scrutiny in the process of Serbia's accession to the European Union.

These Highlights mainly focus on the Analytical Report Accompanying the Commission Opinion on Serbia's application for membership of the European Union. The first part of the Report assesses the political conditions determined by the European Council relative to the state of democracy, the rule of law and observance of human rights, with special emphasis on protection of minorities. Also, regional issues are analyzed, as well as Serbia's compliance with its international obligations. The second part of the Report assesses the fulfillment of economic conditions, in the first place the existence of a functioning market economy and Serbia's capacity to cope with competitive pressure within the European Union.

According to the Commission's opinion, after the year 2000 Serbia has implemented a set of significant structural reforms that have led to a satisfactory degree of macroeconomic stability and the creation of a predictable business climate for all economic factors. The economic policy measures during the previous decade supported relatively high economic growth rates, gradual decrease of inflation and improvement of citizens' living standard.

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The Commission emphasizes that the reforms undertaken after 2000 were in particular aimed at establishing a transparent and reliable system for managing public finances. A set of tax regulations has been introduced to modernize the Tax Administration and improve tax collection. The introduction of Value Added Tax in 2005 contributed to the growth of state tax revenues, and in the same year the budgetary deficit turned into surplus, boosted by favorable conditions for doing business.

The Commission especially welcomed the recent efforts of the authorities to strengthen the legal framework of public finances through rigorous implementation of the new fiscal responsibility provisions. Namely, last year's amendments to the Budget System Law established numerical fiscal provisions and procedures with the aim of setting limitations for the fiscal policy, primarily to strengthen budgetary discipline. Also, the Fiscal Council was established and entrusted with fiscal policy credibility rating from the aspect of compliance with adopted fiscal provisions.

The 2010 pension system reform will, in the Commission's opinion, also help put a lasting limit to public spending. The new Law that will be gradually phased in from 2011 through to 2022, extends the tenure and age limit for retirement, restricts rules for early retirement and adjusts the indexation mechanism.

The structural reforms of the banking system led to the shutdown of four major state-owned banks, while further consolidation and privatization in this sector attracted foreign banks with fresh capital that now dominate the domestic market. Owing to a conservative credit policy and proper supervision of the National Bank of Serbia, the banking sector managed to sustain stability even in the situation when the global crisis shook the Serbian economy. The Commission generally assessed that the banking sector is in good condition, but requires continued vigilance, given that the banks' financial statements are characterized by high euroization, which increases their foreign exchange risk exposure.

Bottlenecks of the Serbian Economy

Although significant market-oriented reforms were implemented in Serbia in the last ten years, the Report highlights the still high number of structural weaknesses which require special attention in the process of Serbia's accession to the Union.

Namely, in the Commission's opinion, the state's influence on the economy remains high, firstly due to the slow progress of privatization which has entirely lost its impetus, additionally curbed by the emergence of the crisis, and a step back was taken through the cancellation of a set of sales and purchase agreements. Certain economic sectors, such as energy, telecommunications and postal services, are still protected from competition. Although the Serbian Government has more than once announced the privatization strategy for large social and state-owned companies, the sales failed, due to a lack of investor's interest. Thus, in the ensuing period the privatization of these, as well as local public utility companies, remains a significant challenge.

The existence of a functioning market economy depends on a free price system and the Commission believes that the process of their liberalization in Serbia during the last decade was slow, taking even an opposite direction. In Serbia the state continues to control prices of services provided by public utilities, and at times it has even frozen prices when faced with a lack of basic provisions.

Removal of barriers to doing business helped reduce the time necessary to register a new company from an average of 23 to five days, which is a significant progress. The process of company establishment was particularly enhanced by introducing a one-stop-shop system ensuring simultaneous registration with the tax authorities, social and health insurance fund and employment service. The implementation of a comprehensive regulatory reform aimed at further removing barriers for doing business and so far the Parliament adopted around two thirds of a total of 304 recommendations. In the Commission's opinion, however, additional efforts are required to eliminate excessive red tape. The new Law on Bankruptcy Proceedings on the other hand significantly enhanced the process of business exiting from the market, and an improved efficiency of the courts in the future would help accelerate this process.

Although efforts have been invested in establishing a legal system, the system of ownership rights still remains insufficiently organized and safe. The process of introducing a digital real estate cadastre and registration process should be finalized by the end of this year and is expected to contribute to increased security of land ownership rights. Additionally, this year's amendments to the Law on Planning and Construction enabled the easier and less costly legalization of illegal construction. However, due to the slow and inconsistent enforcement of the law, there are still delays in the issue of construction permits.

The Report welcomes the enactment of the new Law on Restitution, given that its adequate enforcement should guarantee higher legal safety to investors in the continued privatization process. The lack of trust into the legal system is, however, still hampering the particularly lengthy enforcement procedures when it comes to court decisions.

Although it is not subject of the Report analysis, in the context of the development of an ownership framework it is necessary to emphasize that the Law on Public Ownership has been adopted this year. In this manner another significant step has been taken to regulate ownership relations in Serbia. The Law should enable the delineation of the scope of the public sector and a more efficient management of these assets. With the adoption of this Law, municipalities and cities have become the owners of the property located on their territory, and so have public entities founded by the Republic, province or local government that were previously just beneficiaries of the property owned by the Republic of Serbia. The Law on Public Property is particularly valuable as a precondition for the enforcement of the Law on Planning and Construction, specifically in the domain of privatization of development land. In fact, city development land that has not been built upon can be sold or leased under market terms through public bidding. Thus, the manner in which buyers will be sourced has been established and with the enactment of the Law on Public Property, finally it is known who the seller of a certain city development land plot in public ownership will be: either a local government unit, the Autonomous Province or the Republic. Although this is a real turning point in respect of ownership issues, ever since the adoption of the law no steps have been made towards its enforcement and it has remained unsupported by real action.

Finally, despite measures undertaken to fight corruption, finding loopholes in the legal system continues to be widespread in the environment of a growing informal economy. In order to build trust in the legal system and create equal business conditions for everyone, at the same time attracting new investments, it is necessary to wage a more vigorous war on corruption and bring the grey economy within legal boundaries.

The Report repeatedly warns against continued deterioration of key labor market indicators, despite relatively high rates of economic growth registered in the previous decade. The Commission draws attention to the continued decline in employment rate and activity rate of the working age population, and the high unemployment rate that reached a record 20% following the outbreak of the crisis.

Economic growth accompanied by decline in employment is an issue the other countries in transition face as well, but these were mostly shorter transition periods (of several years at the most) during the mid-transition stage. Serbia, on the other hand has witnessed an uninterrupted employment declining trend since 2001, with a slight exception registered in 2007. The greatest difference between Serbia and the European Union, in terms of labor market indicators, is precisely the employment rate. This difference currently stands at almost 18 percentage points and poses the fundamental obstacle in fulfilling the Copenhagen criteria for Serbia's accession to the European Union.

Although the unemployment rate has additionally increased after the crisis, the Report compiled by the European Commission emphasizes that unemployment is a long-term phenomenon in Serbia and is particularly high among youth. In the opinion of the Commission, there are two factors in particular that contribute to this situation: the regressive tax system and early retirement provisions. As regards the labor taxation system, it must be pointed out that after changes to the personal income taxation regime made in 2007, the earlier regressive system has become mildly progressive. However, compared to the economies in the region and EU member countries, the Serbian economy suffers from a high tax burden for low-skilled workers and workers with lower wages and an average tax burden for highly paid work.

With regard to the quality of human capital, the Report reiterates that the economy suffers from a shortage of qualified labor. The considerable share of unfilled job vacancies and the persistent structural unemployment of persons with secondary or higher levels of educational attainment are indicative of a major mismatch between qualifications and skills. The adoption of the Law on Education System Fundamentals, combined with vocational education and training programs organized within the National Employment Service, are poised to narrow the gap between demand and supply of skilled workforce in the future. Also important for the enhancement of human capital are investments in science, still meager in Serbia (a mere 0.3% of GDP).

In addition to analyzing human capital, the Commission commented on the condition of physical capital in Serbia. Inadequate and low-quality physical capital stock still hampers the productive capacity of the economy. Additionally, the traffic infrastructure is developing at a slow pace and the rail network is outdated due to the scarcity of significant investments in previous decades. Although the telecommunications infrastructure is well developed, the access to broadband network and internet for business purposes still remains at a low level.

With a special reference to the impact of the global economic crisis on Serbian economy, the Report emphasizes that the crisis actually prompted Serbia to deal with the vulnerabilities of the economic growth model applied until then. The model applied until then was mainly based on domestic demand financed by borrowing abroad. Consequently, after a significant turmoil on the global capital market in 2009, the growth trend of the Serbian economy was interrupted. The academic community, however, indicated that the existing model would have collapsed even in the absence of an economic crisis.[12] In fact, in the following couple of years, the exhaustion of privatization resources through sale of companies and the lack of institutional conditions for the capital inflow to be replaced with greenfield investments would have certainly led to scarcity of the capital required to cover the increasing foreign trade deficit and the spending that was higher than the gross domestic product growth. Hence, Serbia should shift to a significantly different, pro-investment and export-oriented growth model in the forthcoming decade. However, the Commission warns that export-driven sustainable growth requires the elimination of the aforementioned structural weaknesses of Serbian economy.

Although the reforms undertaken in the domain of public finances are generally favorably rated, the Report raises concerns in respect of Serbia's fiscal position aggravated by the arrival of the economic crisis. The GDP decline and the depreciation of the Dinar accompanied by a significant increase in the costs of borrowing after 2008, led to an increase in fiscal deficit and the accelerated growth of the public debt. In this respect, the adoption of fiscal provisions mentioned earlier is endorsed – by decreasing the fiscal deficit from about 4.5% to 1% of GDP by 2015 and limiting the growth of the public debt to 45% of GDP, as a way of addressing the deteriorating fiscal situation.

Europe 2020: the Goal and the Instrument

Serbia's convergence towards the European Union in the ensuing period will certainly depend on the progress made in the fields that the European Commission identified in its Report as the "bottlenecks" of Serbian economy. The association process will at the same time be impacted by the targets defined in the Union's new strategy for economic growth titled *Europe 2020*. Namely, Europe highlights *employment growth and reducing inequalities* as the ultimate goals of this strategy. Although these will not be additional criteria for membership in the European Union, the *Europe 2020* strategy targets will inevitably reflect in EU's policy towards countries in the process of European integration. For Serbia – which in the past decade registered divergent trends of GDP growth on one side and a drop in employment figures and increase in inequality on the other – commitment to adopting and implementing these targets should be a priority.

12 *Serbian Post-Crisis Economic Growth and Development Model 2011–2020*, FREN, Economic Institute - MAT, USAID, 2010.

It seems that policy makers in Serbia have already realized this when they begun designing the strategic document *Serbia 2020: the Concept of Serbian Development by the Year 2020,* endorsed by the President of Serbia. This strategy was modeled after the *Europe 2020* document, and sets targets in five key areas: employment growth, enhancement of human capital, investment in knowledge and technology, new model of economic growth driven by exports and based on the rational use of technology, as well as social inclusion and poverty reduction.

The transition to the new, pro-investment and export-oriented growth model should be conducive to convergence towards the European Union, first and foremost by considerably improving unfavorable trends in the employment rate. The sustainability of the suggested new model, however, depends on a number of factors. Some of these factors – such as the time and pace of recovery of the global economy determining the projected export growth – cannot be influenced by Serbia. Nevertheless, what can be influenced is the ability to address the economy's structural weaknesses referred to in the Report, which can be simply subsumed under a single title - public sector reform. Finally, deeper integration with the EU is the only long-term solution for Serbia, in the domain of economic and essential political reforms alike.

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