HIGHLIGHTS

Highlight 1 - Amendments to the Law on Financing of Local Self-Government: An Analysis of Results and Suggested Changes

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From the standpoint of macroeconomic stability and efficiency of use of taxpayer funds, the first results of implementing the Law on Financing of Local Self-governments are extremely negative. Amendments to the legislation had a direct impact on the increase of the overall fiscal deficit in the first quarter of 2012 by RSD 11-12bn. Results from the first quarter confirm the estimates published in the QM even before the enactment of the Law, that its amendments will contribute to the increase of the fiscal deficit by around 45bn RSD in 2012, equivalent to 1.5% of GDP. The growth of fiscal deficits on the basis of decentralisation has directly influenced the increase of the foreign trade deficit, and indirectly the increase of the exchange rate and the creation of inflationary pressures. The local governments have mostly used the additional funds to increase current expenditures on subsidies, on purchase of goods and services, and the increase of wages, while the level of local public investments declined in real terms. Local subsidies have risen by as much as 55%, expenditures for purchase of goods and services increased by nearly 30%, while wages rose by 10% in real terms. The local social welfare expenditures increased by 25% in real terms, but it is not certain how much of this strong increase was well targeted, and how much of it was merely in the service of the election campaign. Furthermore, there are indications that new forms of unproductive spending have occurred at the local level, such as forming of new extra-budgetary institutions, agencies, etc., while at the state level preparations are being made for merging, reducing and cancelling such institutions. Finally, it is expected that in the case of keeping the existing law, there would almost certainly be an increase in the number of employees at the local level, although there is already a high surplus of employees (6-8 thousand) at this level of government.

By increasing the participation of local communities in wage tax by 40% at the expense of the Republic, without transferring the obligations from the state to the local level, a vertical imbalance in public finances in Serbia has been created. Even before the amendments to the Law came into power, the Quarterly Monitor estimated[1] that these changes, all other things being equal, will lead to the increase of the consolidated fiscal deficit in 2012 by about 1.5% GDP2. It also pointed out that fiscally irresponsible changes to the Law on Financing Local Self-governments will lead to a diminished efficiency of the state, i.e. the increased unproductive spending of the taxpayers' funds. Contrary to this opinion, the proponents argued that local communities will use the extra funds to increase local public investments.

As a result of implementing the Law on Financing Local Self-governments in late 2011 and the beginning of 2012, highly divergent trends of real revenue and expenditure have been achieved at different state levels. In Q4 of 2011, Republic of Serbia's budget (RS budget) revenues declined by 10.1% compared to the same period of the previous year, and there was a slight decline in revenues of the Health Insurance Fund of the Republic of Serbia (HIFRS), while the revenues of local self-governments recorded a slight increase (0.3%). Divergent trends became even more pronounced in Q1 2012, when the RS budget revenues continued to decline in real terms compared to the same period last year (by 4.2%), while local government revenues grew strongly in real terms (by as much as 26.1%) compared to the same period last year. Central government revenue decline was primarily a result of the transfer of a substantial portion of revenue from wage tax to the local level, and to a lesser extent the fall in economic activity. On the other hand, growth in revenues of local governments is primarily a result of the additional influx from wage tax, but also of an increase in non-tax revenue, which is a bit of a paradox.3 This suggests that local communities have not used the additional revenues from wage tax for the elimination and significant reduction of various non-tax levies (taxes, fees and other quasi-fiscal duties), even though that was initially one of the arguments for the redistribution of wage tax revenues.

Similar to revenues, divergent trends have been achieved in total expenditures as well. While the state expenditures in the first quarter increased by 10% in real terms, expenditures of local communities have incre-

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1 See Arsić, M. (2012) „Quarterly Monitor no. 24"

2 By subsequent transfer of maintenance of local roads to local self-governments, the impact of the Law on financing local self-governments on the increase of the fiscal deficit has been reduced, but it is uncertain by how much. While the suggested changes to the law claimed that the transferred responsibilities will amount to 10bn RSD, the representatives of the Roads of Serbia claim that the transferred responsibilities amount to 2-3bn RSD.

3 Non-tax revenues of the local levels of the government in Q4 2011 were higher in real terms by 14.7% compared to the same period in the previous year (after making the methodological adjustment for 2010 by excluding the 7 bn RSD of special / once-off non-tax revenues collected by the City of Belgrade).

Table 1 Serbia: Year-on-year (Y-O-Y) growth rate in real terms of public revenues and expenditures by government levels

	Q4 2011/Q4 2010			Q1 2012/Q1 2011		
	Budget of the Republic	Health insurance fund	Local self-governments	Budget of the Republic	Health insurance fund	Local self-governments
A Total public revenues (I)+(II)	-10.1	-0.1	0.3	-4.2	5.2	26.1
I Current revenues (1)+(2)	-8.5	1.3	10.2	-4.3	5.9	30.6
1. Tax revenues	-8.9	0.5	37.3	-4.0	4.7	44.8
1.1. Customs	-21.4	-	-	-18.6	-	-
1.2. Personal income tax	-49.3	-	64.4	-49.7	-	69.9
1.3. Corporate income tax	-3.5	-	-	52.7	-	-
1.4. VAT	1.6	-	-	-4.0	-	-
1.5. Excise duties	-4.6	-	-	4.6	-	-
1.6. Property taxes		-	-5.1	-	-	5.0
1.9.Other taxes	-47.0	-	-13.1	-38.3	-	-9.3
1.10. Social security contributions	-	0.5	-	-	4.7	-
2. Non-tax revenues	-6.0	48.3	14.7	-6.4	242.6	-3.8
II Capital revenues	-	354.1	277.1	61.8	795.7	925.1
III Transfers from the other levels of government	-	-3.7	-39.5		3.7	10.4
B Total public expenditures (I)+(II)+(III)+(IV)	-8.4	-9.1	0.1	10.3	3.3	17.7
I Current expenditures	-3.4	-8.8	-3.3	7.2	3.3	24.5
1.1 Wages	6.4	-10.1	5.4	7.8	2.8	10.5
1.2 Social contributions on behalf of employer	4.4	-9.0	3.9	7.5	1.5	10.3
1.3. Goods and services	-10.7	-4.6	4.7	9.7	1.8	28.6
1.4 Interest payments	10.1	-110.8	45.1	52.8	-88.9	48.3
1.5 Subsidies	-11.3	-	-38.4	36.3	-	55.0
1.6 Social insurance and social assistance	-15.0	-28.8	13.2	-24.0	31.5	24.0
1.7 Transfers to the other levels of government	-1.0	-	-	10.3	-	-
1.8 Other current expenditures	-25.3	-36.7	8.2	-21.9	-	11.8
II Capital expenditures	-41.7	-66.6	9.2	140.1	-	-13.5
III Strategic reserves	-80.5	-	22.1	-92.1	-	62.6
IV Net lending	-42.7	-	14.3	-19.7	-	-7.2

Source: *QM* calculation

ased by nearly 18% in real terms. Much of the real growth of expenditures at the state and local level in first quarter was temporary, i.e. it was related to the discretionary spending and not to the permanent increase of state obligations, and it was directly related to the election campaign. It is therefore expected that after the campaign, the state will bring back its expenditures to "normal" levels, as it simply cannot afford to finance an expenditure growth of 10% Y-O-Y. Quite contrary to this, the local communities will strive to increase their spendings (by hiring new employees, forming new enterprises and agencies), in order to turn the extra revenues from wage tax to permanent "rights".

It is noticeable that the local self-governments used most of the additional tax revenue for increasing current expenditures: wages, expenditures on goods and services, subsidies, and social protection expenditures. For two consecutive quarters, the expenditures on salaries of employees in local self-governments have had a real growth as compared to the same period last year, and this growth is accelerating. In Q4 2011, the RS and local self-government budget spending on employees grew in real terms by a similar dynamic, while in Q1 2012, the real growth of wage bill at the local level (10.5%) was significantly larger than at other government levels (7.8% RS budget, and 3.3% HIFRS). The growth of expenditures on salaries of employees in local self-governments came as a consequence of the adoption of the Decree in late 2011, which made an adjustment to the coefficients for the calculation of earnings of employees in local self-governments, motivated by additional revenues that became available to local self-governments after the application of amendments to the Law on Financing of Local self-governments started.

Similar trends were recorded in expenditures on goods and services as well. In Q4 2011 and Q1 2012, this type of spendings grew significantly faster at the local than at the central level. In Q4 the expenditures on goods and services of the RS and HIFRS budgets declined in real terms, while the same spendings gradually increased at the local level (by 4.7%), compared to the same period last year. In the following quarter, these expenditures had a real growth at all state levels, the one on the local level being the highest, with expenditures on goods and services increasing by 28.6% in real terms, compared to the same period last year, which is three times faster than on the central level. The increase in expenditures on goods and services at the local level recorded in the last two quarters, could be a result of settlement of arrears by local communities for previously acquired goods and services, which is judged to be necessary and justified. However, in that case, it should be expected that the growth of these expenditures would slow down in the coming quarters. If, however, their high growth continues in the future, it will indicate that local communities used the additional tax revenues for permanent increase of current spendings on procurement of goods and services, which is judged to be unjustified.

Apart from spending on goods and services, Q1 also saw a strong growth in real terms of expenditures on subsidies and social assistance, as well as transfers from the budget of local self-governments. The increase of expenditures on subsidies (for local public enterprises) is estimated as unjustified and undesirable from the perspective of economic efficiency, since these expenses are already quite high, and are not related to the results of implementing programmes for improvement of business performance of these companies.

On the other hand, use of additional tax revenues to finance social protection is considered as desirable. However, it is estimated that these are mostly spendings on benefits which are not means tested, in function of the election campaign, rather than well-targeted transfers. At the same time, the data show that capital expenditures at local levels of the government, after a moderate growth in Q4, recorded a higher real decline in Q1 2012, while capital expenditures from the RS budget in Q1 grew strongly (which is a result of delaying settlement of liabilities from Q4 2011 for the next quarter).

Conclusion

Based on the above, it can be concluded that the application of new methods of distribution of revenues from wage tax on significantly contributed to the creation of a high consolidated fiscal deficit in the previous two quarters, as it has enabled an increased current public spendings at the local level, without decreasing the obligations at the state level.

The redistribution of wage tax resulted in the increase of consolidated fiscal deficit by RSD 11-12bn quarterly, i.e. around RSD 45bn annually. Assuming the vertical distribution of income goes back to a sustainable level from the period 2006-2008, which includes a transfer from the state to local communities in amount of 1.7% GDP, the fiscal deficit would be reduced by about RSD 30bn on annual level. In addition to this, increasing revenues of local communities without transferring any significant additional obligations, results in a growth of unproductive spending on salaries, subsidies, procurement of goods and services. Moreover, an acceleration of this process can be expected through the growth of employment at the local level, formation of unnecessary agencies, etc., as well as realisation of investments that are not priorities. In a world of limited resources, where priorities have to be constantly made, it is certainly more important for the advancement of economy and employment growth to modernise the existing core railway lines and build a network of highways, as this will create new jobs in the industry and the production sector, than financing construction of certain aqua parks, sports arenas, etc. as practiced in some municipalities.

It is therefore proposed to bring the distribution of revenues from wage tax between the state and local communities back to the scheme which was applied before the amendments to the Law on Financing Local Self-governments, while the transfers from state to local communities should be increased to 1.7% GDP, i.e. by around RSD 15bn a year. That would mean that the Republic of Serbia would collect 60% of revenues from wage tax, while the local communities would get 40% of those revenues, but also the additional transfer of about RSD 15bn. Alternatively, it is possible to increase the state participation in wage tax to 50%, to have the state pay out transfers in amount of 1.7% GDP, and to transfer to local communities additional obligations in the area of social protection in the amount of RSD 5-6bn, provided that the obligations for maintenance of local roads, transferred to local level amount to RSD 2-3bn.

It is also important to reallocate the wage tax revenues from local self-governments to the Republic as soon as possible, so that the local communities would not turn the temporary increase in expenditures into a permanent one. It will be much harder to realise the reallocation once the local self-governments hire new employees, form new enterprises, agencies, etc.

Literature:

— Arsić, M. (June 2011) „An Analysis of the Proposal to Increase the Local Governments' Share in the Wage Tax“, Quarterly Monitor no. 24, FREN.

— Fiscal Council (June 2011) „Analysis of the Fiscal Effects of the Draft Decentralisation Law Proposed in the Serbian Parliament by 'Ujedinjeni Regioni Serbije'"