

# HIGHLIGHTS

## Highlight 1 - Budget Rebalance and Fiscal Consolidation

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In early September, as the first steps toward medium-term fiscal consolidation, a revised state budget for 2012 was presented, together with the frameworks for fiscal policy for the coming year. In general, fiscal consolidation programme represents a major improvement over policies announced by the current ruling coalition, but also over the fiscal policy implemented by the former government between mid-2011 and mid 2012. Along with the fiscal consolidation measures, a series of regulations that are significant from the standpoint of state regulation in the Serbian public finances have been adopted. These measures are: inclusion of own revenues in the budget, reform of quasi-fiscal levies, regulation of wage policy in the public sector, review of justification for the existence of extra-budgetary agencies, funds and others. Even though the proposed fiscal consolidation has a number of good measures, the following analysis will focus on its weaknesses, in order to suggest possible ways to eliminate them.

Besides some positive changes, the revised budget and the elements of fiscal policy for the next year have several major drawbacks. The first drawback is that the revised budget for 2012 increases the fiscal deficit instead of decreasing it. The increase in the fiscal deficit, even if it is temporary and forced by unforeseen circumstances (drought), seriously jeopardizes the credibility of fiscal consolidation. The increase of fiscal deficit sends a bad message to investors and credit rating agencies, making the achievement of a new agreement with the IMF more difficult. In addition, increase of the fiscal deficit in the last quarter creates a false image of a very high fiscal consolidation in the coming year – maybe a part of citizens will accept such an image, but it is certain that the investors and international financial institutions will not.

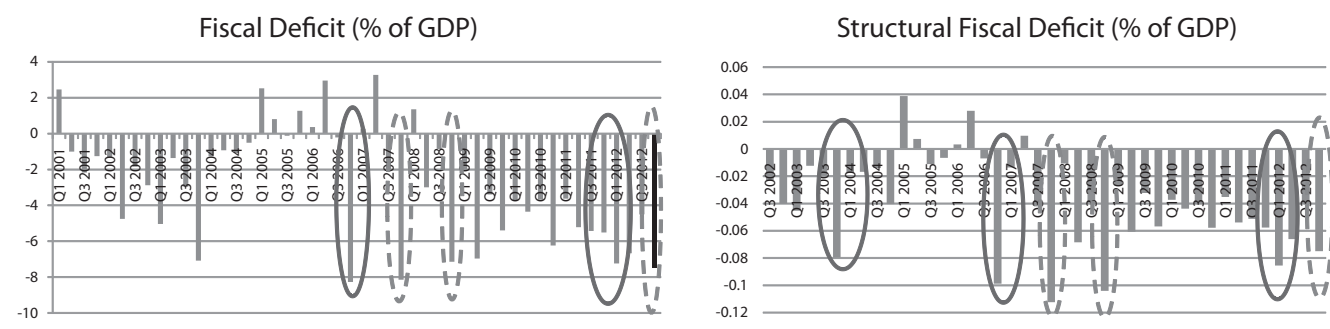
The increase of the deficit caused by the revised budget shows that besides the pre-election expansion in Serbia, there is also a post-election fiscal expansion – while the pre-election expansion wins votes, the post-election one fulfils some of the campaign promises. First significant increase of the fiscal deficit occurred on the eve of the elections held in late 2003. However, after the elections, there was no strong post-election expansion for two reasons. The first reason was that in the first half

of 2004, due to the slow formation of the government, a regime of temporary funding was in force. Another reason was the abandonment of the government of the “developmental” budget, which was one of the main campaign promises of the ruling coalition, and whose implementation would have meant strong fiscal expansion. However, IMF exerted heavy pressure on the then government in order to drop the “developmental” budget – an important instrument of pressure and conditionality was a write-off of debt owed to the Paris Club through application of a restrictive fiscal policy. As a result of this pressure, the government pursued a restrictive fiscal policy until the completion of an agreement with the IMF and the write-off of 15% of the debt to the Paris Club in the first half of 2006. During 2005, a fiscal surplus was achieved, which was the only year since the beginning of transition in Serbia that a fiscal surplus was recorded. However, in the second half of 2006, with the announcement of parliamentary elections, a strong fiscal expansion had begun (launching of National Investment Plan, increase of wages, increase of subsidies, etc.). The possibility of implementing such a policy was facilitated by the expiration of the arrangement with the IMF and by the generated high revenues from privatisation in 2006 (sales of Mobtel, Vojvodjanska Bank, and others). Temporary financing during the first half of 2007 postponed the post-election expansion for the second half of 2007.

Parliamentary and presidential elections of 2008 were called unexpectedly, so there was no pre-election expansion, but the post-election expansion in the second half of 2008 was very strong, although it was clear that a big economic crisis was on its way. The biggest contributors to the 2008 fiscal expansion were two extraordinary increases of pensions – the 12% increase at the beginning of the year, followed by an increase of more than 10% at the end of the year. In addition, a number of other campaign promises were realised as well.

The last election also saw a pre-election expansion. Public expenditures and fiscal deficit began rising from mid 2011 and by the first half of 2012 it had reached enormous proportions. Despite the fact that the economy was in recession, the first half of 2012 saw growth in almost all public expenditures, primarily in discretionary expenditures: subsidies, and spending on procurement of goods and services. However, expenditures on wages and social transfers were growing faster than the statutory dynamic (for more details, see the chapter on fiscal policy and trends).

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**Figure 1. Fiscal deficit and parliamentary elections in Serbia**

Based on the above it can be concluded that over the past decade, the pre-election expansion lacked only when the elections were called unexpectedly, as was the case in early 2008, while the post-election expansion was absent only in periods of temporary financing (i.e. in the period between the election and the formation of the new government), as well as in the period of a solid arrangement with the IMF.

The proposed revised budget for 2012 continues the practice of post-election fiscal expansion. The consolidated fiscal deficit rises from 216 to 222 billion RSD, despite the tax increases in the last quarter. Expansionary fiscal policy would be even higher if the tax revenues had been increased, in which case the fiscal deficit would reach close to 240 bn RSD. The consolidated fiscal deficit in the fourth quarter, according to the proposed revised budget, will be about 70 bn RSD, which is about 7.5% of quarterly GDP.

The amount of the consolidated fiscal deficit in the fourth quarter far exceeds the usual seasonal increase in the fiscal deficit at the end of the year. Comparing the real level of planned expenditures in Q4 of 2012 with the actual expenditures in Q4 of 2011, we get a more convincing confirmation of expansionary fiscal policy. Planned consolidated budget expenditures in the fourth quarter will be about 500 bn RSD, which will generate real growth of over 10% compared to the same quarter last year<sup>2</sup>. In the first half of the year, the real expenditure growth was 4.9%, while the real level of spending will likely stagnate in the third quarter of this year. Specific reasons for increase in the fiscal deficit are detailed in the analysis of the Fiscal Council<sup>3</sup>: payment of the so-called 13th pension, salary increases above the level determined by fiscal rules in certain sectors at the state and local level, increase of subsidies, and others.

In addition to fulfilling campaign promises, the growth of the fiscal deficit in the second half of 2012 was also

influenced by a relatively long period of the formation of the new government and its unwillingness to apply immediately after some necessary but unpopular measures for reducing the fiscal deficit, such as a tax increase. There was a legal possibility of raising taxes as of September 1, before the rebalancing of the budget<sup>4</sup>, which would have reduced the fiscal deficit by 5-6 bn RSD. The revised budget for 2012 made the structure of public expenditures worse by reducing the already modest share of public investment in public spending. Public investment should be a key antirecession stimulus, but also an important measure for the long-term sustainable growth of the economy. The occurrence of unplanned expenses, such as expenses for mitigating the effects of drought in conditions when the fiscal deficit is already very high and unsustainable, cannot be an argument for its further increase. Instead of increasing the fiscal deficit, the means for mitigating the effects of drought should have been provided by reducing other expenses.

Second major drawback of the fiscal consolidation programme is that it mainly relies on increasing revenues, while lacking significant savings on the expenditure side - except in the case of salaries and pensions. The increase in the basic rate of VAT, excise tax, corporate tax, etc. will generate additional revenue of around 1.2% of GDP in the next year, or around 1.5% of GDP in the medium term. It was estimated that the tax increase was necessary because the systemic (structural) fiscal deficit of Serbia is very high (over 4% of GDP), so its reduction exclusively through expenditure cuts is highly unlikely (it is possible only with a reduction in nominal wages and pensions). Relying solely on the expenditures, leads to a relatively slow reduction in the fiscal deficit, which would make the risk of a debt crisis very high. An important argument in favour of tax increases as part of fiscal consolidation is that, even after the increase, the tax rates will still be relatively low compared to the regi-

<sup>2</sup> In order to compare data to the previous year, we used consolidated expenditures that do not include employer social contributions.

<sup>3</sup> Fiscal Council (2012)

<sup>4</sup> Current government of Croatia increased the VAT rate immediately after forming the government and significantly before the rebalancing of the budget, which had a positive effect on fiscal performance of the Republic of Croatia in 2012.

on, which means that it will not jeopardize the international competitiveness of Serbia.

However, as a rule, successful fiscal consolidation programmes are predominantly based on reducing government spending<sup>5</sup>. A typical successful consolidation model is based on one-time tax increase at the very beginning of programme implementation and constant significant reduction in public spending. In contrast, spending in Serbia in the last quarter of 2012 has been rising faster than taxes (despite the tax increase), while its reduction in the coming year is insufficient.

Spending cuts in the coming year mostly come down to savings on salaries and pensions, while other current expenditures (subsidies, spending on goods and services, reducing the number of employees in the public sector, and others) that contain considerable unproductive spending, are not being reduced. Although most of these expenses cannot yield significant savings in the short term, it would be important for the long-term success of the programme and its credibility to start immediately with a reduction in public spending, and that means: reduce or eliminate certain subsidies (elimination of subsidies for new hires, reduction of subsidies for restructuring enterprises and utility companies, etc.), reduce the number of employees in the public sector, realise some savings in the procurement of goods and services, and others.

However, the most significant balance sheet savings in the short term can be achieved by removing the vertical imbalance between revenues and expenditures of the state and local government, by transferring some of the liabilities from the state to the local communities<sup>6</sup>. By partially transferring the funding of salaries of primary and secondary education from the state to the local community, already in 2013 it would be possible to reduce the deficit by 20–30 bn RSD. The effect of eliminating vertical imbalance would be approximately equal to the effect of the VAT increase, without costing the citizens anything, but merely making the state distribute the existing taxes more efficiently. If the vertical imbalance of revenues and expenses is not removed, the reduction of fiscal deficit of Serbia will be slow,

the growth of public debt significant and long-lasting, which jeopardizes the success of the entire fiscal consolidation programme. The relatively fast reduction of the fiscal deficit, which would result in a fiscal balance in four years, besides contributing to the stabilisation of public finances in Serbia and improving its credit rating, would also mean the fulfilment of new, more stringent criteria of the EU, according to which the ceiling of the structural fiscal deficit is 0.5% of GDP.

In addition, it is necessary to formulate this year basic directions of the reform of the sectors of main budget consumers, which are critical to the long term sustainability of public finances in Serbia. That means above all adopting a sustainable concept of the pension system reform, implementing the rationalisation of schools, addressing the issue of restructuring companies as it was done with banks 10 years ago, improving the management of state and public utility companies, etc.

The third drawback of fiscal consolidation programme is that a relatively slow reduction of fiscal deficit is planned, which means that public debt to GDP ratio will grow for at least the next two–three years. High amount of funds needed to finance the fiscal deficit and debt principal payments due under conditions of low credit rating, lack of credible fiscal consolidation, absence of an agreement with the IMF, and the uncertain progress towards EU, opens a serious issue of providing funds to finance them, as well as increasing the costs of financing. Necessary funding of state liabilities, even in the event of strong consolidation, is very high and amounts to about 1.5 bn EUR in the period September–December 2012, or 4–5 bn EUR in 2013.

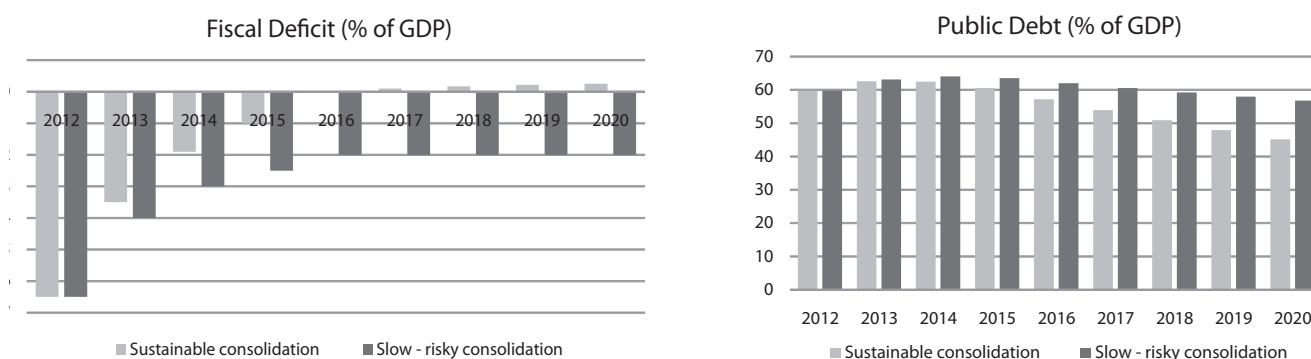
The amount of necessary funds is such that it is highly unlikely that the said funds could be predominantly secured through bilateral agreements with other countries, without a significant involvement of commercial funders. Bilateral funds may, at best, serve to bridge liquidity until an agreement is reached with IMF and country's credit rating improved and stabilised. Otherwise, if no agreement is reached with IMF, the debt crisis is almost certain. Therefore, the public debt trajectory calculated for the scenario of slow fiscal consolidation is more of a computational illustration than a realistic assessment of what would happen in reality. In case of slow, non-credible consolidation that would have no support from the IMF, the fiscal deficit would be reduced spontaneously as it would not have a funding source, which would mean slower growth of public debt, but in that case, GDP would drop significantly, and the dinar would depreciate, so public debt to GDP ratio would be higher than what is presented in the following chart.

<sup>5</sup> In the case of Serbia, another reason for reducing expenditures is that they are high compared to the country's level of development.

<sup>6</sup> The claim that fiscal decentralisation did not increase the consolidated fiscal deficit is false. By transferring about 30 bn RSD (net) from the state to the local communities, the state deficit has been increased by 30 billion, while the balance of local communities remained unchanged, which is why the consolidated fiscal deficit rose by 30 billion. These effects are the result of the fact that state's liabilities remained unchanged while its revenue declined. On the other hand, the local communities used the additional revenues for increasing their spending, which means that the difference between their revenue and expenses remained unchanged. This kind of behaviour of the local communities was predictable, and it is consistent to Friedman's assertion that the state will always find expenses on which to spend the funds received from higher taxes.



## Highlights

**Figure 2. Fiscal deficit and public debt dynamics in the alternative consolidation scenarios**

One of the weaknesses of the new government's fiscal policy is that otherwise good conceptual measures, such as the regulation of the quasi-fiscal levies, are not operationalised in a way that would support fiscal consolidation. Elimination of more than 100 quasi-fiscal levies will reduce the state revenue by about 10 bn RSD (about 0.3% of GDP), which would under other unchanged conditions cause an increase in the fiscal deficit by the same amount. The introduction of quasi-fiscal levies in the budget would somewhat lower the actual losses, but still the net effect of the abolition of duties will be negative. Given the scale of the crisis and the extent of the necessary fiscal adjustment, it is essential to make sure that with the implementation of all measures of fiscal policy their effect on the fiscal deficit be at least neutral, but that they contribute to its reduction. In case of abolishing quasi-fiscal levies, compensation for the lost revenue could be made by increasing the revenue yield of property tax or increasing the corporate tax (see Spotlight On in this issue of QM).

Despite these drawbacks of the current version of the fiscal consolidation programme, restoring Serbia's public finances to a sustainable path is not mission impossible, all it takes is political will. It probably takes the political skill as well to justify giving up on some campaign promises, as well as to correct the bad and unsustainable programmes such as the fiscal decentralisation. It is necessary that the revised budget reduces the spending by 7-8 bn RSD, which could be achieved by giving up on some campaign promises, eliminating certain subsidies, and so on.

In the scope of the budget for 2013, it is necessary along with the planned austerity measures to transfer at least 20 bn RSD of state liability to local communities, as well as continue the reduction of subsidies, number of employees in the public sector by 4-5 thousand a year, to begin reform of all sectors of major budget consumers (pension system, education, health, etc.), as well as reduce the growth of interest costs by restoring investor confidence, etc.

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