

# SPOTLIGHT ON:

## Does Serbia need a fiscal consolidation and how can it be realised<sup>1</sup>

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At the end of May, the Fiscal Council proposed a comprehensive and consistent programme of fiscal consolidation, which contains measures whose aim is to achieve a balanced budget by year 2016. This implies reduction of fiscal deficit by 1% of GDP this year and by 2% of GDP next year. The largest part of fiscal consolidation would be achieved by reducing current expenditures (-5% of GDP) and, to a lesser extent, by raising taxes (+1% of GDP), while an increase in public investment is proposed (+1% of GDP). The immediate objectives of fiscal consolidation are to ensure macroeconomic stability in order to prevent a public debt crisis and reduce external imbalances, while the ultimate goal is creating conditions for growth in economic activity and employment. Programme of the Fiscal Council is not the only one possible, so new proposals and alternatives are welcome. However, it is estimated that some alternative proposals that have emerged in the first days after the publication of the Fiscal Council's programme, do not contribute to the improvement of fiscal consolidation, but rather directly threaten its goals. The first group is made up of populist proposals according to which, a minor adjustment in fiscal policy is needed that could be realised by an improved collection of taxes, savings in public procurement, elimination of certain subsidies, and others, while freezing of salaries and pensions, as well as raising taxes are unnecessary. The second group consists of libertarian proposals according to which consolidation can be achieved by eliminating all subsidies, laying off half of the employees in the public sector or by reducing spending on goods and services by 50%. While the populist proposals basically mean a delay or abandonment of fiscal consolidation, which would lead to a debt crisis, the libertarian proposals would secure fiscal consolidation, but would lead to a destruction of some of the basic functions of the state (education, health care, security, etc.), which would jeopardize the ultimate goals of the fiscal consolidation – growth of GDP and employment.

### Introduction

Public debt of the Republic of Serbia exceeded the legally prescribed limit of 45% of GDP at the end of 2011. The Law on Budget System prescribes that, during the adoption of the new or a rebalance of the current budget, the Government of Serbia adopts a credible plan for mid-term consolidation of public finances, which would enable the public debt in the coming years to return to sustainable, legally prescribed parameters and thus avoid a potential debt crisis.

In the recent report “Proposed Measures of Fiscal Consolidation 2012-2016”, the Fiscal Council of Serbia analysed in detail the current state of public finances in Serbia, quantified the necessary extent of savings in short and mid term, and suggested a list of possible savings in various segments of Serbia's public sector. It was estimated that in the absence of urgent measures of fiscal consolidation, the fiscal deficit would exceed 200 billion RSD this year, which is 50bn RSD above the amount foreseen by 2012 fiscal policy. In order to avoid a debt crisis and a liquidity crisis in a short time, the Fiscal Council estimated that by 2013, it is necessary to realise savings of around 1bn euros. Also, in order to secure solvency of public finances and stabilise the level of public debt, it is necessary to reduce the budget deficit, in the mid-term from 2014 to 2016, by additional 1.2bn euros, in order to achieve a balanced budget by year 2016, and return the public debt to its legal limits.

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## Does Serbia need a fiscal consolidation and how can it be realised

In addition to quantifying the problem, the Fiscal Council also analysed various parts of the public sector, as well as possible savings for each one of them. They started with “socially acceptable” austerity measures, that were broadly discussed in the public in the last months – a systematic fight against the grey economy and tax evasion, improvement of public procurement processes, dissolving agencies and other state institutions whose duties could be performed within a government ministry, rationalisation of state subsidies, and cancelling the negative effects of the so-called fiscal decentralisation of last year. However, having in mind the scope of the problem and a huge gap between budget revenues and expenditures, the necessary savings cannot be achieved solely by popular measures, and it is clear that the pending fiscal consolidation has to include two of the most significant budget items – salaries and pensions on the side of expenditures, and VAT on the side of revenues. Economically speaking, it is almost always optimal to implement fiscal consolidation on the side of expenditures, without raising the taxes. However, that would require a one-off (nominal) reduction in salaries and pensions by 5-6%, followed by their freezing for one year. Given the social and political challenges that would follow a nominal reduction of salaries and pensions, the Fiscal Council also presented a scenario that does not involve a reduction of salaries and pensions, but only freezing them over a period of 18 months. However, this scenario requires an increase of both VAT rates by 1 percentage point, as well as increasing excise on tobacco products and alcoholic beverages, in order to close the gap between the budget revenues and expenditures<sup>2</sup>.

Fiscal Council’s programme is not the only possible programme for achieving fiscal consolidation in Serbia, but for now, it is the only complete and consistent programme. New initiatives and alternative proposals, as well as more detailed elaboration of the proposals within the programme, are certainly welcome. However, some of the alternative proposals that emerged in the first days after publishing the Fiscal Council’s programme do not contribute to the improvement of the programme, but would rather mean abandonment of fiscal consolidation or collapse of basic functions of the state.

For quite some time in the general public, among the politicians and economists, there have been claims about the public finances in Serbia that are far away from reality. This is probably one of the reasons that unfounded and unsubstantiated proposals are emerging for solving problems in Serbian public finances. These proposals can be categorised in two basic groups. The first group consists of proposals whose application is justified, but they drastically overestimate their affect on state balance sheets and ignore the time dynamics that these measures would have on public finances – proposals from this group can be described as populist. This group consists of suggestions for improvement of tax collection, combating grey economy, improvement of public procurement, dissolution of redundant state bodies, reducing the number of employees in the public sector, etc. All these suggestions are necessary and indisputable, but their affect on the state’s balance sheet is insufficient to bring the public finances in Serbia back in sustainable parameters, and in addition, it would take several years to achieve savings by applying these measures.

The allure of these suggestions is in the fact that they seemingly offer a solution for sustainable fiscal consolidation that would not affect the broad strata of the population (potential voters), but only corrupt officials (public procurement), dishonest businessmen (grey economy) and useless bureaucrats (dissolving redundant government bodies). However, relying exclusively on these measures will not lead to the necessary reduction of fiscal deficit, which means their implementation would delay fiscal consolidation. To what extent these measures are unrealistic is also confirmed by policies implemented in other European countries, that have a smaller grey economy, more efficient public procurement, more productive bureaucracy, and still most of them were forced during this crisis to apply tough austerity measures (freezing or reduction of salaries), as well as a considerable tax increase.

The second group consists of proposals mainly from the academic (libertarian) circles, whose application would lead to a fast fiscal consolidation, but also to a drastic collapse or abolishment of some of the basic functions of a modern state. These measures include suggestions for cutting the number of employees in the public sector by half, to eliminate all subsidies, and halve the spending on goods and services. The division in these two groups is conditional, since the proposals in the second group often present an extreme version of otherwise necessary and justified savings.

The following will analyse several proposals from the first and second group, in order to point out their weaknesses.

<sup>2</sup> Fiscal Council also proposed a tax reform, which is similar to the proposal put forth two years ago, and which was supported by the then Minister Dragutinovic. The most important measures in tax reform are the increase of fiscal burden of consumption and the reduction of the fiscal burden of labour. Fiscal Council’s proposal includes increasing the standard VAT rate to 22%, as well as transferring 1/5 of products, observed in value, from reduced to standard rate of VAT, and a reduction in tax burden of average earnings from 65% to 54%. In addition to that, the tax reform proposes an increase in excise duties on cigarettes and alcoholic beverages, abolition of tax reliefs for taxes on profit, increased coverage of assets with taxes, as well as abolition of a number of quasi-fiscal duties, or their merger and reduction.

## 1. Fiscal consolidation is completely unnecessary

Some opinions can be heard in the public that Serbia doesn't really need a fiscal consolidation – that the current large gap between the budget revenues and expenditures is the result of the global economic crisis and that public finances will balance themselves out once the crisis is over. However, the imbalance in public finances of Serbia is of structural nature and stems only by a small part from the global economic crisis, and for the most part from the systematic imbalance between taxes and public expenditure policies. Systemic imbalances in Serbian finances appeared in the mid 2006, when the previous arrangement with the IMF was completed, and the country generated high one-off privatisation revenues (Mobtel, The Vojvodjanska Bank, Belgrade Department Stores, etc.). Unfortunately, the revenues from privatisations were not invested in the infrastructure, but were used for unsustainable increase of public expenditures, on the one hand (salaries and pensions were significantly increased in 2007 and 2008), while on the other hand, the tax revenues were decreased (in 2007, there was a reduction in tax on earnings, and some products were transferred from the higher to the lower VAT rate). The last big systematic blow the Serbian finances suffered in 2011, when as part of the so-called fiscal decentralisation 400 million euros of tax revenues were transferred from the state budget to local self-governments, without the corresponding transfer of responsibilities and liabilities. That is why the problems of public finances of Serbia are of structural nature, and the Fiscal Council's proposal actually foresees solving the problems through applying measures contrary to those that caused the problem in the first place, meaning: reduction or at least freezing of salaries and pensions as a response to the unsustainable increase of 2007 and 2008, cancelling out the negative effects of the so-called fiscal decentralisation from 2011, as well as increase of tax rates (VAT) as a response to the unsustainable unilateral reduction of taxes on earnings and the switch to a lower rate of VAT from 2007.

## 2. The situation in Serbian public finances is not extremely risky, and therefore requires relatively moderate adjustments of the existing fiscal policy

At the basis of this opinion, there is a belief that Serbia's public debt is not that high compared to the debts of the developed countries, and therefore no harsh measures are necessary in order to reduce the fiscal deficit. It is concluded that there is no need for a VAT increase or freezing of salaries and pensions, and instead, all that is needed in order to achieve fiscal consolidation is an increase of excise, savings in the procurement of goods and services, suppression of grey economy, reduction in subsidies, and a gradual rationalisation in the major spenders' sectors (education, health care, etc.).

A mild adjustment of fiscal policy implies a gradual reduction of fiscal deficit and a continuation of the high growth of public debt in the coming years. This would mean a continuation of the fiscal policy from 2009-2010. However, the circumstances have significantly changed compared to the stated period: public debt of Serbia has reached 50% of GDP, a series of debt crisis in Europe have diminished investor confidence in the solvency of the states, expansionary policy no longer has the support of IMF, and salaries and pensions in Serbia were frozen at the time.

It is estimated that a mild adjustment of fiscal policy in Serbia is very risky, because it would significantly increase the likelihood of a debt crises. A continuation of a high fiscal deficit policy would directly influence the maintenance of high deficit in current balance of payments. In that case, the entire burden of bringing the foreign deficit back to sustainable levels would lie on the depreciation of dinar, which would considerably increase costs of servicing the foreign debt of the state, enterprises and citizens, and with a certain time lag, there would be an increase in inflation as well. To the extent that the depreciation of dinar would not reduce the external imbalance, NBS would be forced to spend foreign exchange reserves, and to tighten the restrictiveness of the monetary policy. Any termination of the agreement with the IMF could trigger a suspension of financing of the public debt and fiscal deficit of Serbia by commercial investors. Also, it is estimated that revenues from any sales of a public enterprise or a bank would not be sufficient to replace the commercial investors who finance the fiscal deficit and the public debt of Serbia.

When considering whether Serbia needs a strong fiscal consolidation or just mild adjustments of the existing policy, we need to remind ourselves that most of the European countries in the last two years increased their tax rates and applied severe austerity measures, that led to a reduction of the share of primary fiscal deficit in GDP, on average by about 3 percentage points. Former Yugoslav countries were late in this process, but they are currently implementing programmes of strong fiscal adjustment. Slovenia, whose share of public debt in GDP is similar to Serbia, while its fiscal deficit is lower, adopted severe measures of austerity, which include a reduction in nominal salaries in the public

sector. Croatia increased its VAT rate, announced relatively mild austerity measures, but apparently that will not be sufficient, so they will have to adopt additional austerity measures. So a question arises – are the economists and politicians of European countries wrong, and are overestimating the risk of a debt crisis and ignoring the need for fiscal stimuli, or are perhaps some Serbian economists and politicians wrong?

### **3. The public debt of Serbia is not a problem, but rather the borrowing limit of 45% of GDP is set unrealistically low**

An opinion can often be heard in the public that the public debt limit for Serbia of 45% of GDP is set too low, because the EU member states have a prescribed limit of public debt of 60% of GDP. However, this comparison is inadequate as it omits one of the most important factors that affect a sustainability of a debt – credibility/solvency of the debtor. Thus the developed countries that have a high credit rating and a history of successful loan repayments in the past, can afford a higher level of debt than the developing countries, such as Serbia, who have in the past few decades relatively often gone through the process of restructuring and writing off the public debt.

Higher credit rating allows the developed countries to borrow at much more favourable conditions than the transitioning countries, such as Serbia. For example, interest rate on twenty or thirty-year American or German bonds is around 2%. On the other hand, Serbia is forced to borrow against five-year (or shorter) dinar bonds at the rate of 15%.<sup>3</sup> Therefore, it is clear that Serbia cannot afford the level of public debt that some of the developed Western countries can.

Empirical studies show that in the past, half of the developing countries entered a crisis with the level of public debt amounting to 43% of GDP or less. That is why the transition countries in the region target the level of public debt that is much lower than 60% of GDP, which is prescribed for EU member states. For example, last year neighbouring Bulgaria adopted fiscal rules prescribing a maximum public debt of 40% of GDP. Other countries in the region (Slovenia, Romania, Slovakia) are either applying or planning severe measures of fiscal consolidation, with the level of public debt relative to GDP similar to or lower than Serbia.

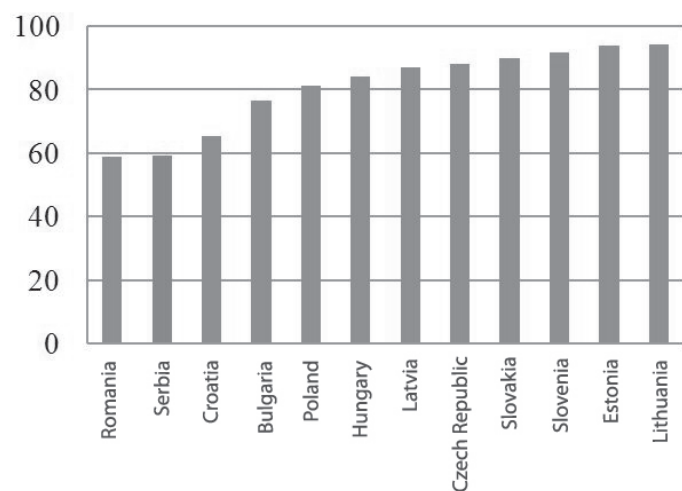
### **4. Serbia has an enormous surplus of employees in the public sector, so it is possible to lay off half of the employees at the state level or at the level of the republic administration. Laying off of extra employees would achieve considerable savings, without compromising the availability and quality of public services.**

The public sector in Serbia, excluding public enterprises, employs around 440 thousand workers, out of which there are 34 thousand employees in the republic administration. Around 12% of GDP is spent on salaries of public sector employees, while around 0.9% of GDP is spent on salaries of those employed in the republic administration. It is apparent that the expenditure of the employees in the public sector are unsustainable in the long term, but there is a question whether this is predominantly a result of an excessive number of employees or salaries that are high compared to the private sector and to the level of economic development.

The first question to be answered is whether there really is an enormous number of employees working in the public sector in Serbia. A rough answer could be obtained by comparing the number of public sector employees per 1000 inhabitants in Serbia and other countries. This comparison is quite relevant, as the number of public sector employees in relation to the population stems from the functions performed by states, and most European states are performing similar functions. For example, all states perform functions such as defence, internal security, and judicial functions, and for these sectors there are empirical norms set as to how many soldiers, policemen, judges, etc. per capita are needed. Over the last 100 years or so, the European countries have taken on some new functions, such as public health care, public education, social protection, etc. The state's involvement in these sectors is the result of the inefficiency of the market<sup>4</sup>, as well as the progress of civilisation that implies that certain services, such as primary and high school

<sup>3</sup> Nominal interest rate of 7.25% that Serbia pays on a 10-year dollar bond issued last Autumn, is just a portion of the cost of servicing the debt. In addition to this amount, it is necessary to include the amount of depreciation of dinar against the US dollar, which was over 20% in the meantime.

<sup>4</sup> Inefficiency of the market in the stated sectors is the result of asymmetric information and negative selection that it would lead to, moral hazard, existence of external effects, etc. State intervention is justified by an opinion that some services, such as education and health care, should be available to all citizens, regardless of their financial means.

**Figure 1. Employment in public sector per 1000 inhabitants**

Source: World Bank (2010)

can still be concluded that this surplus is not enormous, i.e. 30% or 50% of the total number of employees, as some experts and politicians are claiming.

Additional evaluation of the employee surplus in the public sector could be performed by a microeconomic research of productivity at the level of individual institutions: hospitals, schools, municipalities, police stations, courts, tax administration, etc. World Bank conducted such a research in 2008 for some of these sectors and it was estimated that employee surplus in education was 5-7 thousand. Similar results were obtained in the case of health care as well, where the identified surplus in non-medical personnel was around 6-8 thousand. During 2009, the government of the Republic of Serbia conducted a comparative analysis of the employment in the local self-government, and found that the surplus of employees at the local level is 6-8 thousand.

It was also estimated that there is a surplus of employees at the republican level of 4-5 thousand. The sum of all previous numbers gives a surplus of employees at the state level of around 5% of the total number of employees. Based on these estimates, it would be possible to lay off around 25 thousand employees in the public sector, without affecting the quality and availability of public services. Of course, the implementation of these measures would not be painless, which is probably the reason why it has been delayed for several years now, even though there were concrete plans for the rationalisation of the network of schools, health institutions, reduction of number of employees in local and state administration.

**Table 1. Total number and structure of employees in the public sector**

Central level administration	34.313
Local level administration	60.810
Military	36.000
Police	48.414
Justice	21.723
Culture and social protection	7.798
Education	125.127
Health care	104.599
<b>Total</b>	<b>438.784</b>

Source: Fiscal Council

education, and partly higher education as well, or health care services, should be available to all citizens. And it is precisely these services that now employ the largest number of employees working in modern states, and Serbia as well.

A comparative review of the number of employees in the public sector<sup>5</sup> per 1000 inhabitants shows that the total number of employees in Serbia in relation to the population is among the lowest in the group of the observed countries. Aside from this, it can be observed that the number of employees in the public sector per 1000 inhabitants is moving in a relatively narrow intervals, which is the result of the abovementioned normatives that stem out of the functions of the state.

It cannot be concluded from the above that there is no surplus of public sector employees in Serbia, as it is possible that the number of public sector employees in all states that Serbia is compared to is excessive, but it

<sup>5</sup> The state sector implies the sector of general government, i.e. all those institutions that are directly and indirectly financed from fiscal or quasi-fiscal resources.

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Another, more common proposal is to halve the administration at the republican level. It is important to remember that the republic administration performs some of the functions, without which it is hard to imagine even a classic, let alone a modern state. It is possible to reduce the number of employees by 4-5 thousand and still have the state perform its functions equally as well as it does now. The preliminary analyses also show that the stated surplus is mainly among the employees at the ministries, administration of social security funds, the Republic Geodetic Authority, etc.

**Table 2. Total number and distribution of employees in public administration at the level of the Republic**

Pension Fund (PIO) administration	3.264
Republic Fund of Health Insurance (RZZ) administration	2.420
National Employment Agency (NSZ) administration	1.992
Republic administration	26.637
Customs administration	2.842
Tax administration	6.856
Treasury department	1.245
Geodetic authority	2.670
Employees at the ministries	6.672
Other employees at the republican level	6.352
<b>TOTAL, administration at the level of the Republic</b>	<b>34.314</b>

Source: Fiscal Council

Naturally, this does not mean that it is unnecessary or impossible to reduce the cost of employees in the public sector, but this would mainly be done by reducing the gap in salaries between the public and the private sector. Based on the comparative analysis by countries, it is concluded that the salary gap between the public and private sector in Serbia is bigger than in other countries. Even though this gap, presented in the chart, is probably overestimated due to the fact that part of the salaries in private sector is paid in cash, it is still large. Even if the differences in salaries between the public and the private sector were adjusted based on the difference in the level of education, they are still great. Therefore, it can be concluded that both from the economic and moral perspective, the salaries in the public sector should be frozen in order to reduce these unjustifiably large differences.

**Table 3. Salaries in the public sector and the rest of the economy, 2008**

Country	Salary gap between the public sector and the rest of the economy in %
Serbia	39,6
Latvia	31,9
Hungary	30,1
Estonia	24,6
Slovenia	27,4
Lithuania	28,0
Poland	24,9
Romania	20,3
Bulgaria	27,2
Slovakia	22,6
Czech Republic	20,3
<b>EU 10 – average</b>	<b>25,8</b>

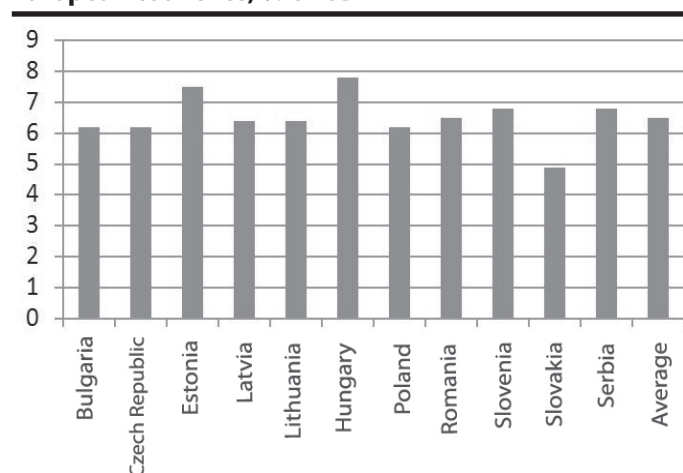
Source: IMF

It can thus be concluded that the savings on salaries in the public sector are possible and necessary, and most of them could be achieved by freezing salaries during 2012-2013, and then raising them at a rate slower than that of GDP,

in line with the fiscal rule. Freezing, followed by a slower growth rate of salaries than that of GDP would decrease the share of cost of labour in the public sector by 1-1.5% of GDP in the next few years, depending on the height of inflation and growth rate of GDP. The savings from reducing the number of employees are not negligible and in the next few years could amount to about 0.5% of GDP. In order for this measure to lead to permanent savings, it is very important to make thorough preparations, so that laying off employees, whose engagement is necessary in the public sector, can be avoided. This is exactly what happened in Serbia in 2006, when public sector laid off employees who were essential for its functioning (anaesthesiologists, professors of mathematics, physics and English, etc.), with high severance pays. Therefore, the state had a double expense – first for severance pays, and then for hiring new employees with the same qualifications. A possible attempt to halve the number of employees at the level of the Republic would yield high fiscal savings, but it would require a drastic reduction of all state functions or elimination of certain functions, and this would mean a huge economic and civilisational step backwards.

## 5. It is possible to significantly reduce or even halve the expenses on purchase of goods and services in the public sector, because there is corruption in public procurement.

**Graph 2. Expenditures on goods and services, selected European countries, % of GDP**



Source: Government finance statistics, Eurostat, for Serbia - Bulletin of Public Finance

Expenditures on goods and services consist of very heterogeneous items among which the most important are the expenditures on the purchase of medicines in health care, on heating and other utility services, expenditures on fuel and electricity, on maintenance of state owned buildings and equipment, expenditures on office material, etc. The accounting item “expenditures on goods” in Serbia is also credited with expenses for financing salaries of employees in scientific institutes (The Vinča Institute, institutes in the fields of biological and medical sciences, etc.) in the amount of around 10bn RSD (0.3% of GDP), which artificially increases the cost of procurement of goods and services. When it comes to possible expenditure on goods and services, it is necessary to keep in mind that the scope and structure of these expenses is to a large extent defined by functions of the modern states and by technology, so the resulting difference in the share of expenditures on goods and services in GDP by countries is relatively small. The differences in prices at which the states procure goods and services, move in a relatively narrow interval, especially when it comes to goods that are subjects of international trade. In Serbia, prices of medicines, fuel, computer equipment, office material, army and police uniforms, and auto spare parts are on average similar to those of surrounding countries. Prices of certain products, such as the utility services, electricity, gas or of labour (e.g. salaries of scientists, ITs, consultants, etc.) on average are lower in Serbia than in the region. For these reasons, the expenditure on goods and services in Serbia, seen as the % of GDP, is at an average level of new EU member states.

The preceding facts disprove the estimates of many economists and politicians, who see in expenditures on goods and services a great potential for savings. There are some savings potentials in them, but they are far from justifying halving these expenditures or reducing them by 600 million euros.

This raises a question of why there is a mass-spread belief that these costs can be drastically reduced? The answer to this question is that there is probably a methodological error, where the observed irrationalities in an individual case are extrapolated to all procurements in the public sector<sup>6</sup>. Simply put, just because a certain product or service is procured at a 30% higher rate than that of the market, does not mean that all products procured by the state are paid at higher than market rates. Moreover, it is not even possible, because a large part of what the state procures

<sup>6</sup> Other contributing factors are the lack of data on the amount and structure of public procurement by type of goods and services, state levels, as well as lack of data on prices at which government bodies are procuring goods and services. This data should be collected, processed, published and then used for analyses by government bodies that are responsible for public procurement and fight against corruption. Instead of data and detailed analyses on where exactly the unproductive spendings are and how much they are, their representatives quote anecdotal observations that are available even to the laymen, and based on them draw general, often wrong conclusions.

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relates to public utilities, electricity, fuel<sup>7</sup>, etc. procured from public enterprises at prices that are even lower than the market prices.

The second reason why potential savings are overestimated is that too often a fact is ignored, that in many sectors the state is not purchasing enough quantities of goods and services. An insufficient public procurement of goods and services is in some cases transferred to the citizens, even though they have already paid taxes and contributions in order to get a particular service (e.g. medicines and other medical services), while in other cases, there is simply an insufficient procurement of goods and services for providing educational, medical and security services<sup>8</sup>.

It cannot be concluded from the above that there are no irrationalities or corruption in the public procurement of goods and services, but it is certain that they are smaller than could be concluded based on individual cases. In order to achieve savings from procurement of goods and services, it is necessary to improve the system of public procurement and toughen the fight against corruption. However, a large part of thus created savings should be used for improving the quality of state services, meaning: better supply of medicines, introducing new generation medication, better supply of the army, the police, education, etc. Finally, one should bear in mind that prices of certain goods and services that play a significant role in state expenditures, such as utility services, electricity or gas, will almost certainly rise in the future, so the state will have bigger expenditures on the procurement of the same quantities of the mentioned goods. It can be estimated from the above that net savings from procurement of goods and services will amount to around 0.5% of GDP.

Indirect confirmation of the assessment that savings of several percentage points of GDP or 600 million euros on procurement of goods and services cannot be achieved, comes from the fact that Serbia has approximately the same percentage of expenditures for goods and services as new EU member states, although these countries on average have a better system of public procurement and lower levels of corruption. Possible attempts to halve the stated expenditures, as suggested by some economists, would jeopardise some of the basic functions of government, which have highest expenditures on procurement of goods and services (health care, police, military, tax administration, etc.).

### 6. It is possible to eliminate all subsidies and thus save 3% of GDP

Subsidies from the budgets of the Republic, local self-governments and extra-budgetary funds, amount to around 3% of GDP. This section registered over the last few years some of the most drastic unproductive spending of tax payers' funds. Subsidies in Serbia are significantly higher than in other countries, so the Fiscal Council recommends reducing their share in GDP by 2% in mid term. In addition, there would be a reduction or elimination of subsidies that are not included in state's consolidated balance sheet, and which are approved through the Development Fund and other extra-budgetary funds.

However, some economists propose eliminating subsidies in their entirety and in this way solve to a large extent the problem of fiscal consolidation in Serbia. Naturally, the elimination of subsidies would by almost 3% of GDP help the fiscal consolidation, but the question is whether that would be economically and socially justified. In case of implementation of such a policy, Serbia would probably become the only country in the world that does not approve any subsidies. Complete elimination of subsidies is also unjustified from the perspective of economic theory, as it would reduce the amount of goods that create positive external effects.

Aside from that, practical ramifications of such a measure would be drastic: it would almost certainly lead to termination of the railways, the prompt initiation of bankruptcy for all companies in process of restructuring, and the loss of about 100 thousand jobs. With the elimination of agricultural subsidies, Serbia would become the only country in Europe that does not grant such subsidies, which would adversely affect the already low competitiveness of our agriculture, reduce exports, etc. Reducing subsidies for utility companies would require a one-time increase in utility prices and the price of public transport in Belgrade for several tens of percent.

While temporary elimination of subsidies for restructuring companies and other enterprises under the jurisdiction of the Privatisation Agency could be considered, it is our estimate that elimination of subsidies for agriculture and railway is economically and socially unjustified. Besides, the reduction of subsidies for local utility companies should be gradual and in parallel to the reduction of costs of their operations and a raise in prices for their services.

<sup>7</sup> Estimates of possible savings often ignore these expenses, which are quite important in terms of balance sheets, but have little room for savings.

<sup>8</sup> Anecdotal examples are: the lack of anti-hail rockets, lack of spare parts for military aircrafts, obsolete police equipment, and others.



## **7. Raising taxes is not necessary, as the required growth of revenues can be achieved by a more efficient taxation of the grey economy.**

There is an opinion often present in the public that additional revenues could be generated by a more efficient taxation of the grey economy, without raising the taxes. It is a bit paradoxical to give such categorical statements about potential revenues from the taxation of the grey economy, without a single substantial research on grey economy being done in Serbia in the last 10 years. Instead, some quite unsubstantiated estimates have appeared in the public, which are mainly based on anecdotal observations that are, by virtue, misleading. And the explanations given often contain major methodological errors<sup>9</sup>, which further reinforces the doubts about the validity of such estimates.

A more precise answer to the question of how additional funding can be achieved by taxing the grey economy, requires that it first be estimated. In addition, it is necessary to bear in mind that even in the most organised of states, there is a grey economy and it is nowhere less than 10% of GDP. However, even this estimate may not be enough, because the assessment of possible revenue growth must also take into account the state of tax administration in Serbia and the necessary time to improve it.

Certain economic activities can survive only if they are, to a bigger or lesser extent, performed within grey economy, and in the period of crisis, the percentage of such activities increases. Therefore, a zealous attempt to tax these activities would lead to their elimination, and the government revenues would temporarily drop. Shutting down stores, restaurants and businesses that operate partly in grey economy and partly legitimately, would mean loss of revenue for the state not only from the taxes these businesses were paying, but also from the consumer taxes paid by their employees.

One of the arguments that could considerably deny the possibility of generating significant additional revenues from grey economy is that the share of tax revenues in Serbia's GDP is high in relation to the tax rates. The conclusion would not be different if the GDP increased by around 15%, by how much it is probably underestimated. The share of tax revenues in Serbia's GDP would still be high in relation to the given tax rates, which means that the grey economy in Serbia is not significantly higher than the average.

Of course, one cannot conclude from the above that there is no potential in Serbia for generating additional revenue by more efficient taxation, but this potential is a lot smaller than the necessary revenue increase. It is estimated that a better organisation of tax administration would in a relatively short time increase the tax revenues by around 0.5% of GDP – this would be achieved by improving the technology of payments of taxes and salary contributions, suppressing corruption in tax administration, etc. After that, the additional revenue increase from grey economy would face greater difficulties, because a strict application of regulation would imply the closing down of shops, blocking of enterprises, enforced collection of claims, etc. – which would in turn cause a reduction in state revenues. General suppression of grey economy can hardly be realised without solving a general problem of financial indiscipline, and at the core of this problem are companies going through restructuring.

## **8. It is not necessary to freeze pensions, but only to collect debts of companies towards the pension fund or realise savings in some other items.**

Opinions on the possibility of resolving the pension fund deficit by collecting debts of companies towards the Pension Fund (PIO) have often been presented in the public. It is clear that, even if these receivables were collectable, they would not be able to increase the revenue of the Pension Fund permanently, but rather only once. However, the majority of these claims are related to the enterprises undergoing restructuring and other failed public and private companies, so the best case scenario would entail collecting merely several percent of the total receivable amount – by publishing the list of biggest tax debtors, this became obvious even to the general public.

Avoiding freezing of pensions by realising additional savings on some other expenditure items would also be impossible, because those savings are already taken into account in the fiscal consolidation programme. Namely, the

<sup>9</sup> E.g. Often in the estimates of grey economy, gross value is quoted, and not the added value. In addition, in some cases, a partial tax evasion is treated as a total one. The grey economy is mixed with activities not covered by the statistics, that are subject to taxes, and sometimes the non-taxable activities are considered as grey economy, such as the sale of agricultural products on the green market. In addition, financial indiscipline is often mistaken for grey economy, cases where tax payers regularly report their obligations, in order to avoid criminal charges, but they don't pay them, as they are insolvent – e.g. this is often the case with enterprises undergoing restructuring.

consolidation programme includes savings on other expenditure items, except for public investments and social aid. However, these savings are not enough to reduce the public spending to a sustainable level, so the freezing of pensions is necessary. If, however, the freezing of pensions is not accepted, a sustainable fiscal consolidation would require even bigger savings on other items, which could mean: reduction of nominal salaries instead of their freezing, elimination of subsidies to companies undergoing restructuring, and launching bankruptcy for all listed companies, additional savings on goods and services, which would probably lead to shortages in the public sector, etc.

### **9. Budgetary and extra-budgetary agencies and funds should be dissolved, and thus realise savings.**

Savings in this area are possible and are counted on in fiscal consolidation, but they are not of great significance to balance sheets. Regardless, it is necessary to eliminate unproductive spending in this area, in order to show that there are no privileged or protected institutions or individuals. The room for savings lies in the overlap of responsibilities between various agencies, between agencies<sup>10</sup> and line ministries, as well as in the improved parliamentary control of their expenses, including the cost of salaries and procurement of goods and services. In some cases, it is possible to dissolve agencies and funds or to merge them together or with certain ministries.

However, some agencies were established in order to take over certain government functions that were often in conflict with interests of political parties that were members of the government (Agency for Protection of Competition, Telecommunications Agency, Energy Agency, Anti-corruption Agency, State Audit Institution, Office of the Ombudsman, etc.). International experience shows that establishment of such agencies creates an opportunity to promote activities within their jurisdiction. Besides, the establishment of these agencies is part of the EU integration process. In these cases, the focus of activities should not only be on effective control of agencies' expenses, but also on improving the efficiency of their operations, which means that the Agency for Protection of Competition would successfully prevent abuse of monopoly position, the Anti-Corruption Agency would detect individual irregularities in the procurement of goods and services, etc.

There is a lot of confusion in the public about expenditures of agencies, so some of the oldest functions of the state are classified under agencies, such as Security Information Agency (BIA), Military Security Agency (VBA), etc. Therefore, dissolution of such agencies would not be acceptable if we want to have a sovereign state. If we want to have a state, we need to pay for it, and funding of the state through borrowing is possible only in the short term, as shown by examples of many other countries.

### **10. VAT should not be increased. All austerity measures should be implemented and tax collection improved before possibly increasing the VAT.**

This position is a direct outcome of overestimating potential cost savings in positions of current spending, in particular cost savings for the purchase of goods and services, reduction of number of employees, elimination of various state institutions, as well as overestimating possibilities of generating additional revenues from better taxation of the grey economy. Essentially, this view represents a special case of claim no. 2, whereby the state and trends in public finances of Serbia are not particularly risky, and therefore require only a moderate and gradual adjustment of the current fiscal policy.

Implementation of such a policy would lead to a fast realisation that these savings are not enough, that fiscal deficit is still high, and the accelerated borrowing would rapidly continue.

Another drawback of this proposal is that realisation of such savings requires considerable time, and preventing the further growth of debt requires a fast and considerable reduction of the fiscal deficit. Therefore, the only real alternative to the increase of VAT is a reduction of the nominal level of salaries of the public sector employees and the pensions<sup>11</sup> - that is the only way to rapidly and considerably reduce the fiscal deficit, without raising the taxes.

<sup>10</sup> The public has created confusion regarding the functioning of agencies, funds and other institutions, as well as possible savings in this area. It is a very diverse group of institutions, some of which are classic budgetary institutions such as the BIA, VBA, etc., while others are relatively new extra-budgetary institutions, which have their own extra-budgetary income. The only thing that is common to all these institutions is that they are called agencies.

<sup>11</sup> In case of pensions, it is not certain whether or not their reduction is legally possible, i.e. whether it is constitutional.

## **11. Increasing VAT will not lead to an increase in revenues, because the companies will move to grey economy, or a milder argument – increase of revenues will only be temporary, and will then drop in relation to GDP, requiring another increase of VAT in a year or two.**

Empirical studies, which estimate the isolated effect of raising the VAT rate on revenues, show that this increase on average leads to a considerable increase of state revenues<sup>12</sup>. A similar conclusion can be reached by simply observing the movement of revenues from VAT in relation to GDP in the countries that have increased the VAT rate over the years. In all countries that have increased the VAT rate during the last recession, there was an increase in the share of VAT revenues in GDP<sup>13</sup>, while revenues from other taxes have mainly dropped. Still, a more precise estimate of the effect of an increased VAT rate on tax revenues requires an application of econometric models in order to control the influence of other factors (change of aggregate demand structure, negative cyclical effect of the production gap on VAT in the period of recession, etc.) on VAT revenues.

However, what is indisputable is that the tax increase alone in the case of Serbia is not enough for fiscal consolidation. That is why the Fiscal Council proposed a programme where 4/5 of consolidation are carried out by reducing the current expenditures, and only 1/5 by raising taxes. Therefore, if the state only increases the VAT and does not implement austerity measures on the side of expenditures, or implements them only partially, the state will find itself in a real problem in a year or two.

### **Conclusion**

Populist proposals on fiscal consolidation are partly the result of ignorance about public finances in Serbia, although that is not the only reason. Part of the reason is a consequence of an intention of some economists and politicians to offer seemingly fast and painless solutions, that would not affect majority of citizens, but such solutions simply do not exist. Sometimes, the populist proposals are formulated by the opinion that burden of fiscal consolidation should not be on the citizens of Serbia, but rather the government. However, the government is not a physical entity, so it cannot bear the cost of fiscal consolidation.

It would be good if the entire burden of fiscal consolidation is reduced to the elimination of socially and economically unacceptable expenditures, such as the abolition of fees related to public procurement, reduction of high salaries in the agencies and funds, the lay off of redundant civil servants, and the collection of taxes from the privileged and dishonest businessmen. Unfortunately, this is not possible, because the savings on socially unacceptable expenditures are insufficient, so it is necessary for the significant part of the cost of fiscal consolidation to be born by the citizens of Serbia. The only question is how these costs would be distributed: would the majority of the burden be born by the public sector employees (freezing of salaries), the public sector beneficiaries (pensioners, subsidy beneficiaries), or all citizens of Serbia (increase of VAT). It would seem that many proposals for fiscal consolidation contain a misleading or deceptive belief that there are measures that will not affect anyone but the corrupt and redundant civil servants and the privileged and dishonest businessmen. Offering easy, fast and painless solutions by some economists indicates a lack of responsibility, as well as a breach of some elementary professional standards.

At the other end of the extreme, in relation to populist proposals, are the libertarian proposals that contain radical measures, such as: elimination of all subsidies, lay off of the half of employees in the public sector, reduction of salaries and pensions by 20-30%, which would in principle secure a fiscal consolidation, but would have extremely adverse economic and social effects. While the populist proposals essentially mean a postponement or abandonment of fiscal consolidation, the libertarian proposals would result in a collapse of some of the fundamental functions of a modern state, such as public education and public health care.

### **Literature:**

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2. Fiscal Council (2012) "Proposed Measures of Fiscal Consolidation 2012-2016"
3. EU (2012) "Taxation trends in EU"
4. World Bank (2008) "How to Do More With Less"

<sup>12</sup> It is unusual how much the Serbian economists believe in the Laffer curve, even though its validity is not empirically substantiated very much.

<sup>13</sup> EU (2012) Taxation trends in EU