SPOTLIGHT ON:

Fiscal Consolidation and Recovery of Serbian Economy

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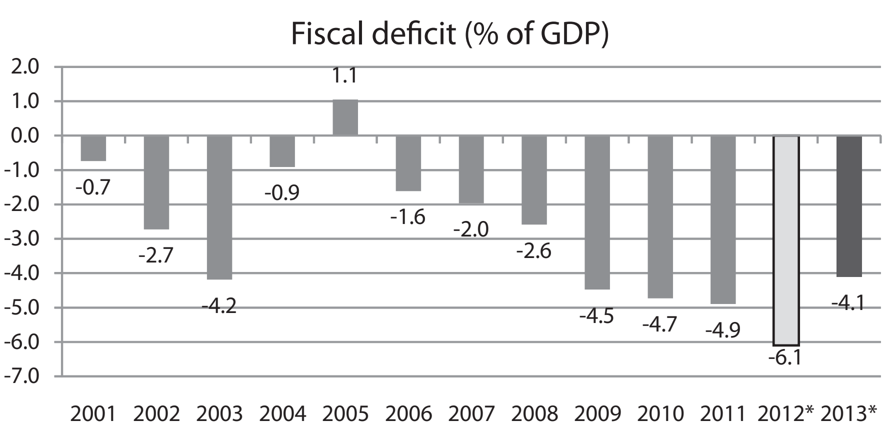
Proposed programme of fiscal consolidation reduces the probability of debt crisis, but it does not eliminate it. The 2013 programme for fiscal consolidation, which includes tax increase, reduction in spending and increase in one-off revenues, realises approximately one third of necessary reduction of fiscal deficit. The remaining two thirds of fiscal adjustment in the period 2014-2015 should almost exclusively be realised through reduction in spending, which implies structural reforms in all publicly funded sectors. The goal of public sector reforms, beside reduction in spending, should also be improvement of its efficiency. During the period of fiscal consolidation, the government will need considerable funds to finance the deficit and pay the interest due – necessary funds will be secured only if the confidence of investors is preserved. The effects of fiscal consolidation on economic growth will be positive in the case of Serbia, even in the short term, because the relevant alternative to fiscal consolidation is the debt crisis and recession, and not economic recovery with high fiscal deficit and additional borrowing. Fiscal consolidation is the first urgent step towards bringing the Serbian economy back on the sustainable growth path. However, for long-term sustainable recovery and growth of economy, in addition to fiscal consolidation it is also necessary to have fundamental reforms of the economic system, because in case of Serbia the effective limits to economy's growth lie on the supply side rather than the demand side. Competitive dinar exchange rate and improvement of business environment could mitigate negative effects of unfavourable economic developments in the region and reduction in domestic demand.

1. Dynamics and structure of fiscal consolidation

Proposed programme of fiscal consolidation presents a significant turn compared to the fiscal policy led from mid-2011 and during 2012. Fiscal deficit in 2013 will probably drop by 2-2.5% of GDP. If in the next year additional austerity measures are not adopted, the fiscal deficit will probably be higher by around 0.5% of GDP than the planned level, i.e. it will be around 4% of GDP instead of the planned 3.6% of GDP. Therefore, the fiscal deficit will be reduced by around 30-40% compared to 2012, rather than by one half as officially estimated. The reduction of fiscal deficit in the following year is significant compared to an extremely high deficit that was created in the election year of 2012. However, the 2013 deficit will be slightly lower than the realised deficits of 2009 and 2010. That is why the 2013 fiscal policy can be interpreted as returning to the sustainable path that we strayed from as of mid-2011.



By reducing the fiscal deficit in the coming year, approximately one third of fiscal consolidation will be realised, which is necessary in order to stop the rise of public debt in relation to GDP, and then start its reduction as well. Slightly less than half of the reduction of fiscal deficit in 2013 is due to the net increase in taxes, while the remaining part is mostly the result of real reduction of pensions and public salaries, as well as the increase in one-off revenues in the amount of 0.5% of GDP. Tax increase (VAT, excise duties, corporate income tax, etc.) will bring additional revenues of around 1.5%

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of GDP, but the abolition of quasi-fiscal levies and reduction of customs will cause a loss of revenue of around 0.5% of GDP. Hypothetically, if the taxes have not been increased the fiscal deficit next year would be over 5% of GDP, which is on the same level as 2011, but above the realised fiscal deficit of 2009-2010.

Important question for economic policy is the nature of fiscal deficit, i.e. to what extent is the fiscal deficit the result of cyclical and temporary factors and to what extent is it the result of systemic discrepancy between tax policy and spending policy, as well as long-term macroeconomic and demographic trends. If the fiscal deficit is the result of cyclical factors, it will spontaneously be eliminated with the recovery of economy. Otherwise, if the fiscal deficit is the result of structural factors, then its elimination requires reduction of expenditures and/or increase of taxes in relation to GDP. By applying relevant statistical procedures, it is possible to roughly estimate how much the realised deficit is the result of cyclical and temporary factors and how much of it is the result of systemic factors.

In 2012, structural or systemic fiscal deficit in Serbia was approximately equal to the actual fiscal deficit, because the effects of the recessions (fall of GDP) were offset by the increase in domestic demand, i.e. by the absorption gap1. In Serbia, the production and absorption gap affect equally the tax revenues and fiscal deficit2, and their deviation from equilibrium is also equal but in opposite direction. While in 2012 the non-agricultural GDP will be around 4 p.p. below the equilibrium level, the current account deficit will be about 4 p.p. higher than the long-term sustainable level. It can be concluded from the above that the fiscal deficit in Serbia is entirely structural in nature, which means that it will not be eliminated with the recovery of economy – what will be gained by higher taxes due to GDP growth will be lost by lower taxes due to the reduction of demand and its restructuring towards less taxed forms (investments and export).

Tax increase as a way to reduce fiscal deficit in 2012 was necessary, but in future, a more considerable increase of taxes would not be justified. A more significant tax increase would jeopardise Serbia's competitiveness, which would discourage employment and investments, and by the same token the growth of GDP. A revenue-neutral tax reform would be desirable in the coming years, which would change the structure of the tax system in the sense of creating favourable conditions for investment and employment.

Since tax reforms in the future will be mostly revenue-neutral, the remaining reduction of fiscal deficit from the level of over 4% in 2013 to the level of 1% in 2015 should be realised by decreasing the share of public spending in GDP. That means that, for example, in 2014 it will be necessary to reduce the share of public spending in GDP by 2-2.5 p.p. which is twice as much as the reduction of expenditures that will be realised during 2013. If in 2014 the GDP would grow at a rate of let's say 4%, it would facilitate the decreasing of share of public spending in GDP, but it would still be very difficult and it would require considerable savings in almost all segments of public spending, including public investments and social protection. From the standpoint of fiscal consolidation, it is relevant that due to restructuring of economy towards exports and investments in the future, the tax revenues will be growing slower than the GDP.

For now, there is no clear plan from the Government as to how this reduction in public spending will be realised. Therefore, in order to keep the credibility of the programme of fiscal consolidation, it is necessary to turn the general determination to reduce public spending into concrete steps by the end of the first quarter of 2013. Instead of general opinions that a reform is necessary, credible fiscal consolidation requires for the Government to precisely determine which measures and when they will be taken in order to reduce the spending by the planned amount.

Recovery of Serbia's economy and success of fiscal consolidation programme depend significantly on investors' trust in Government's economic policy. First reactions of investors to the published fiscal consolidation programme in Serbia were positive, which was then reflected through low interest rates on Serbia' borrowing on the international financial market in the period September – November of this year. Still, low interest rates are not only the result of investors' confidence in the economic policy of the Serbian Government, but also of the increased liquidity on international financial market due to a strong monetary expansion of Fed and ECB. Just how important this factor is can be observed from the fact that other countries from Central and Eastern Europe have borrowed money with lower interest rates in the period September – October 2012: Poland 3.75%, Czech Republic 3.87%, Romania 4.5%, Bulgaria 4.25%, while Serbia in the same period was paying interest rates of 5.25 – 6.5% [3]. Similar conclusions are reached by comparing yields from trading government bonds on secondary markets (see chapter 6).

1 Negative production gap affected the fall of revenues from direct taxes, and positive absorption gap affected the higher revenues from indirect taxes.
2 See Arsić et al (2012)
3 In order for the comparison of interest rates to be adequate, it is necessary that they refer to the same period, since conditions on global financial market change relatively quickly. It is also necessary to take into account the differences in maturity of issued bonds.

Despite the favourable conditions of borrowing on international financial market, the investors' trust in Government's economic policy and business perspectives in Serbia is still low. Risk premium for Serbia is among the highest among the countries of Central and Eastern Europe (see chapter 6). For a successful recovery of Serbia's economy, it is not enough for the trust to stay at the existing low levels. Longer lasting trust of investors into the economic policy and business perspectives in Serbia would be confirmed only if country's credit rating would increase. However, there are still no indications that something like this can be expected. On the contrary, there are risks that current modest level of trust could be lost either because of a significant deviation from the fiscal consolidation programme or because of some unforeseen shocks (e.g. continuation of recession in EU and Serbia).

This is why it is very important for Serbia to sign a new arrangement with the IMF beginning of next year, in order to strengthen the credibility of Serbia's economic policy. Relying exclusively on the trust of private investors is an overly risky strategy, because it can be lost relatively quickly and the repercussions for Serbia would be highly negative.

2. Fiscal consolidation and economic growth

Fiscal consolidation, as a rule, has different effects on economic growth in the short and mid term. Short-term effects of fiscal consolidation on economic growth depend on what is the relevant alternative to fiscal consolidation: continuation of the policy of high fiscal deficit and borrowing or public debt crisis. If the relevant alternative is the continuation of the policy of high fiscal deficit and borrowing, then the fiscal consolidation influences the slowdown in economic growth. Reduction in spending (government and partly private spending financed by the government) and increase of taxes, *ceteris paribus*, will influence the fall of domestic demand and thus the slower growth of GDP as well. The quantitative impact of the reduction of government spending on the growth of GDP depends on the size of fiscal multipliers – the lower they are the lower the impact of fiscal consolidation on the slowdown of the economic recovery. Previous alternative is relevant for the countries that have high credit rating and relatively low ratio of public debt to GDP. However, if the relevant alternative to fiscal consolidation is a public debt crisis, then fiscal consolidation in the short-term as well has positive impact on the economic growth.

Having in mind that at the end of 2012, public debt of Serbia will reach 60% of GDP, and that Serbia's credit rating is very low, we estimate that the relevant alternative to fiscal consolidation for Serbia would be public debt crisis. That is why a fiscal consolidation even in the short-term would have a positive effect on the economic growth. Public debt crisis would result in the fall of GDP and employment by 5-10%, which is significantly higher than the negative effect of fiscal consolidation on the economic growth.

However, from an analytical point of view, it is interesting to see how large is the negative effect of fiscal consolidation on economic growth relative to a hypothetical (but unsustainable) continuation of expansionary fiscal policy with an annual deficit of around 6% of GDP. Negative effect of fiscal consolidation on economic growth in this hypothetical case is equal to the product of fiscal multipliers and level of fiscal adjustment, i.e. the amount of lowering the structural fiscal deficit relative to GDP.

Based on comparative analysis done for similar countries, it can be estimated that fiscal multipliers in Serbia are 0.2-0.3. Indirect confirmation of low values of fiscal multipliers in Serbia can also be obtained based on the modest effects of enormous fiscal expansion on GDP growth in 2012. Despite the fiscal deficit of around 6% of GDP, non-agriculture GDP had zero growth this year. It follows that reduction of fiscal deficit in 2013 by 2-2.5% of GDP, all other conditions unchanged, would influence the slowdown of economic growth by around 0.6% of GDP. Similarly, total fiscal consolidation in the period 2013-2015, which reduces the structural fiscal deficit by around 5% of GDP, would influence the reduction of GDP growth by around 1.25% relative to a hypothetical growth that would be realised with the continuation of expansionary fiscal policy. Negative effects of fiscal consolidation on the growth could be even smaller provided that fiscal consolidation is credible, because in that case the rise in private investments and consumer spending would partially offset the negative effects of fiscal consolidation. Based on this, it is estimated that the negative impact of fiscal consolidation on the slowdown of economic growth would be small, even in relation to the hypothetical growth of GDP that would be realised with the continuation of expansionary fiscal policy.

It is expected that the effects of fiscal consolidation on growth of the economy in the medium and long term would be positive on several grounds. However, how positive the effects would be depends on the way the fiscal consolidation would be implemented, as well as to what extent it would be accompanied by reforms of the public sector and economic system. The proposed programme of fiscal consolidation relies predominantly on the reduction in spending, which is in line with the practice of successful programmes. Total planned reduction of structural fiscal deficit in the

Level of fiscal miltipliers in Serbia

Estimates of fiscal multipliers span on a wide interval from 0 to 1.5. In the case of Serbia, fiscal multipliers are almost certainly on the lower limit of the stated interval, because most of the factors that influence the value of multipliers act towards their reduction. In Serbia, as a small open economy, most of the fiscal stimuli are spent on exports and not on getting the domestic production going. Dual currency system that exists in Serbia has resulted in high variability of exchange rate that responds to the smallest changes in monetary and fiscal policy, and then on the increase of prices as well, which reduces the high values of fiscal multipliers. High inflation, that has been present in Serbia throughout the recession, prevents the implementation of expansionary monetary policy that is applied in other countries. Restrictive monetary policy, which is forcefully applied in Serbia, instead of the usual accommodating monetary policy, reduces the values of fiscal multipliers. Other factors as well that affect the value of fiscal multipliers, such as the amount of public investments, the trust of investors and citizens, cause the fiscal multipliers in Serbia to be low.

Looking at the types of fiscal incentives that were applied in Serbia during the current recession, it is estimated that most of them were relatively ineffective. One of the rare stimuli that proved effective was the subsidy for bank loans. Efficiency of this measure is manifested in the fact that by using relatively modest government funds, approval of much higher sums of business loans is encouraged. Subsidies on loans are a sort of forced measure that offsets the ineffectiveness of monetary policy in a dual currency system. In a dual currency system, the standard mechanisms of monetary incentives, such as the reduction of key interest rate or reduction of reserve requirement, are spilled over to the foreign currency demand, instead of using the increased liquidity to increase the number of loans issued to businesses and citizens. That is why even a slight deviation in monetary policy leads to a significant depreciation of dinar and acceleration of inflation, instead of the increase in loans and economic activity.

period 2013-2015 is 5 p.p. of GDP, out of which only 1 p.p. is realised through tax increase and the remaining 4 p.p. through expenditures cuts. Fiscal consolidation should reduce the share of public spending to around 40% of GDP, which is adequate for a country with a development level of Serbia and in line with the targeted long-term economic growth of Serbia of 4-5% annually. Public spending of around 40% of GDP, fiscal deficit between 0 and 1% of GDP, and a reduced ratio of public debt to GDP will have a positive effect on credit and investment rating of Serbia, which would contribute to a reduction of interest rates and growth of investments.

The effect of fiscal policy on growth depends not only on the amount of total tax burden and public spending, but also on the structure of the tax system and public spending, as well as the efficiency of the public sector. From the standpoint of economic growth, it is more favourable for the tax on consumption and property to be higher and taxes on factors of production lower. High taxes on factors of production increases their price, which in the long term leads to a reduction in speed of capital accumulation and slower growth of employment, and thus to slower economic growth as well. Increase of share of public investments and reduction of share of current public spending would have a positive effect on economic growth. For a long-term sustainable economic growth, an efficient public sector is of utmost importance, and it should provide favourable conditions for economic development and this involves securing simple laws, good quality transport, energy and telecommunications infrastructure, educated workforce, etc.

3. Fiscal consolidation and public sector reform

However, the reduction in spending is not the only goal of public sector reform. Structural reforms need to be implemented so as to realise savings in the government sector and at the same time preserve the availability of government services and improve their quality. In principle, fiscal consolidation could be achieved by reducing public investments, but that would be utterly disastrous for long-term sustainable growth of Serbian economy. Similarly, education or health reforms that would limit the availability of the governmentd services to the citizens of Serbia or diminish their quality, could not be considered successful even if they would provide savings that are necessary for fiscal consolidation. Such reforms would ensure macroeconomic stability, but they would not contribute to the long-term sustainable growth of Serbia's economy.

Fiscal strategy contains general determination to realise structural reforms, but it gives no concrete measures or deadlines for their implementation. So for example, pension reform is stated as an important priority, but not how or when it would be implemented: whether actuarial penalties would be introduced for early retirement and awards for late retirement, what would be the dynamic of increasing the minimum retirement age requirement for women, etc.? Similarly, the Fiscal strategy plans education reform, but not the measures by which to implement it, will it go for the rationalisation of primary and secondary schools, how would the enlargement of classrooms be achieved, is there a plan to introduce mandatory secondary education and if so, when, which measures would encourage the improvement of quality of education at all levels, from primary education to doctoral studies, would the financing of low quality public universities continue, what would be the conditions of government financing of studies on private universities, etc.?

By the same token, when it comes to subsidies, one of the expenditure positions that needs considerable savings in the future, there is no plan for reduction and elimination of some of the more contentious subsidies such as the subsidies for job posts, investors, etc. Moreover, the agricultural subsidy policy is not consistent either, because simultaneously there are subsidies by hectare that encourage reduction in production and subsidies by quantity of manufactured products that incite an increased production.

Surplus of employees in the public sector, that representatives of current Government (both before and right after the elections) were estimating to hundreds of thousands, which was extreme exaggeration, are now being completely ignored. Some statements were made that time of crisis is a bad time for lay-offs, which is absurd because the lay-off of excess workers is the way to solve a crisis.

From the standpoint of Government's credibility, it is necessary for sector reforms that are adopted for a certain area (education, health protection, agriculture, subsidies, culture, science) to be consistent with Government's Fiscal strategy. Instead, in most sectoral strategies an increase of share of expenditures in GDP is planned – if that would happen, the share of total public spending in GDP would increase as well, instead of decrease. In most of the strategies, the priorities are increased spending of funds, while efficiency of spending (possible savings, quality of service, etc.) come second. The lack of harmonisation between sectoral strategies and Fiscal strategy reflects the absence of coordination within the current Government, which was the case with previous Governments as well. One of the consequences is that sectoral strategies, which are not fiscally sustainable, remain unimplemented or even worse, lead to an increased unproductive spending.

Removal of vertical imbalance between revenues and expenditures on various government levels is important both from the standpoint of fiscal consolidation and improvement of public sector efficiency. This imbalance can be removed in several ways: by increasing the government share in wage tax, transferring some of the functions from central government to local self-governments or by reducing money transfers to local self-governments. From macroeconomic viewpoint, the first solution would be the best, but because of the opinions of current Government representatives it seems that it is out of the question and that transferring certain responsibilities to the local level is more probable. If certain authorities are transferred to the local level, from the standpoint of fiscal consolidation, it would be important to make the transfer significant for the balance sheet, which means that responsibilities in the amount of at least 20 bn RSD should be transferred. From the standpoint of economic efficiency, it is important that transferred responsibilities on the local level are performed at least as efficiently as they were at the government level. Some difficulties can be foreseen with transferred responsibilities to the local level due to an expressed regressivity of fiscal decentralisation – poorer municipalities will not be able to take on additional duties. However, the richer ones will express great resistance towards taking on additional responsibilities – it can be expected that they will request additional funds for additional functions.

Within the public sector reform, in realising public investments and other government programmes such as subsidies, it is necessary to introduce a mandatory application of cost-benefit analysis. And for credibility of this analysis, it is important that justification of the analysis is assessed by a body that is independent from the one proposing it – ministry or the Government. Implementation of cost-benefit analysis would prevent realisation of socially unprofitable projects, as well as prioritising among the feasible projects. A question arises whether there was even a feasibility study for the construction of railroad Valjevo-Loznica or channel Dunav-Morava-Vardar-Aegean sea? Ministry of Finance should not ignore such proposals, because their possible financing would cost several billion euros, while their profitability is highly doubtful. Also, in the case of feasible projects, it is necessary to introduce priorities in order to avoid extensive borrowing of the government or starting a large number of projects without finishing them. Before the approval of the subsidy programme, as well as during its implementation, it is necessary to introduce legally required analysis of their economic viability. Required application of a project's feasibility study would gradually spread to other government programmes, such as the programmes for education, health, improvement of capacity of public administration[4] and others.

4 During the last decade, a large number of programmes has been realised, whose aim was to improve the capacity of public administration – such programmes were mostly financed by EU and individual countries. However, there is an impression that most of the realised programmes yielded very modest results.

4. Economic system reforms and economic growth

In a small, open and euro-pegged economy such as Serbia, demand incentives do not have a significant influence on economy's recovery in the short term. In such an economy, fiscal and monetary policy have very limited antirecession range, so every attempt to use them to get the economy going influences more the rise of inflation and external deficit than it encourages economic activity. Therefore, the goals of fiscal policy should be limited to sustaining macroeconomic stability (low inflation, low possibility of public and external debt crisis, etc.), while the conditions of long-term sustainable economic growth should be created through reforms of the public sector and the economic system. Realisation of structural reforms that would reduce the cost and risks of doing business in Serbia, would enable the expensive and inefficient measures to be abolished, such as various types of subsidies, and that would directly contribute to the realisation of fiscal consolidation. In addition to not being able to incite high and sustainable economic growth of employment, these subsidies grossly violate the equality of market participants and create fertile ground for corruption and fraud.

Proponents of the policy of widespread and generous subsidies, as an argument in favour of their implementation, state that economic activity and employment would be even lower without them. This would be true only if the existing economic system were treated as given and unchangeable. But since economic system reforms are possible, and some even in the short-term, the above explanation is unconvincing. Therefore, the reasons for delaying reforms and relying on subsidies could be more easily found in political economy. Reforms affect in various way the influential interest groups (employers, bureaucrats, politicians), but also the voters (workers, pensioners), so they are constantly delayed due to short-term political interests. On the other hand, subsidies give great discretionary power, which creates room for various annuities, and in some cases they temporarily increase political popularity of those who approve them.

Structural reforms that would reduce the cost and risks of doing business in Serbia and create a more favourable environment for investing and doing business are numerous and various, but listing and explaining them is beyond the scope of this paper[5]. That is why in this paper we will limit ourselves to a few of the most important structural reforms, whose realisation is necessary in order to establish functional market economy in Serbia and create favourable conditions for growth and investments[6].

Establishing financial discipline and introducing firm budget constraints represent probably the most important reform for improving business environment. The lack of financial discipline is manifested through the problem of illiquidity, but a more detailed analysis shows that behind this problem is the insolvency of a large number of market participants. If the problem were solely illiquidity and not solvency, it would be solved relatively easily by increasing expansionary monetary policy. Existence of insolvent companies generates large risks and costs, because market participants are not sure whether, when and in what percentage they would be able to collect their receivables. Existence of a large number of insolvent market participants creates losses for solvent companies and banks, who are unable to collect part of their receivables. These risks are reflected in the reduction of the number of transactions, high interest rates, and high prices of goods and services that serve to charge the solvent companies for the losses created by doing business with insolvent ones.

Although establishing firm budgetary constraints in this area was stated as one of the most important goals of the transition in Serbia over two decades ago, no significant progress has been made, because there were always reasons/excuses to delay its realisation (sanctions, attempt of restructuring, world economic crisis, etc.). Insolvency in Serbia is not solely a characteristic of former government-owned enterprises, but of many private ones as well. Owners and managers of insolvent companies, regardless of whether they are public or private companies, continually try to transfer the costs of their recovery to the government, more precisely to all citizens – tax payers. Mass insolvency of private companies, in addition to some objective unfavourable circumstances for doing business (redundant technology, global crisis, high interest rates), is mostly the result of the fact that the existing entrepreneurial class in Serbia developed on the redistribution of wealth and privileges and that it is not capable of surviving in an equal market competition.

Current Government came out with several measures that are important for establishing financial discipline, such as limiting terms of payment primarily for the government and then for companies and entrepreneurs as well. These measures are necessary for establishing financial discipline, but they are not the most important ones. The most important measure for establishing financial discipline is the efficient application of bankruptcy procedure by which

5 A good guide for necessary structural reforms in Serbia could be the reports of World Economic Forum on comptetitiveness and World Bank report on conditions of doing business. Although these reports have certain weaknesses, especially when it comes to indicators that are not measurable but are the result of perception (see Ristić and Tanasković, Quarterly Monitor no. 25-26), bad placement of Serbia in certain areas on the stated rankings indicates which reforms are priorities.

6 Proposals of the stated reforms can mostly be found in the study "Post-crisis Model of Economic Growth and Development in Serbia 2011-2020", in chapter Arsić, M. "Public Sector Reforms". Proposals from this study are still current since most of them have not been realised to date.

the insolvent companies would change owners and be liquidated. Even though some progress has been made in this area, there are still large problems: companies in restructuring are legally protected from bankruptcy, and many insolvent private companies avoid bankruptcy in various ways. Announcements of Government representatives that restructuring of companies will have a time limit until mid-2014 are encouraging, but a full effect will be realised only if bankruptcy procedures are efficiently applied on these companies in case of their insolvency. In order to solve the problem of insolvency, it is important that prices of services of infrastructure companies are increased in line with economic principles. As long as there are companies who are selling their products below the cost price, the problem of financial indiscipline will be difficult to solve.

In addition to an indiscriminate elimination of insolvent companies from the market, it is necessary to adopt relevant legislation that would dramatically increase the criminal liability of businessmen - frauds that are serially forming new companies, accumulating obligations in them and then once these obligations reach a level where they far exceed the assets, they start bankruptcy proceedure and establish new companies.

An integral part of measures for establishing financial discipline is the systematic and indiscriminate fight against shadow economy. Widespread grey economy grossly violates the equality of business conditions for legal entities, but also for the citizens. While some businesses and citizens are paying their taxes regularly, others are partially doing business in the grey area, while some are almost entirely avoiding paying taxes. Indiscriminate collection of taxes would contribute to creating clear distinction on the market between solvent and insolvent companies.

Important obstacle for doing business in Serbia are long and non-transparent procedures for acquiring various permits, which result in the increase of costs and risks of doing business. The most negative consequences on economic growth in Serbia come from slow and non-transparent procedures for issuing building permits, that directly affect the reduction in scope of investments, employment and growth. Even though this problem has been identified over a decade ago, no satisfying solution has been found so far at the government level, although there are some local communities that have made significant progress. That is why it is necessary to adopt a law that would prescribe strict procedures, their duration, cost of services, sanctions for those who do not adhere to those procedures, etc. in order to solve this problem efficiently[7].

The most important goal of tax reforms in the coming period is the improvement of investment environment and employment. The most important tax reform is the increase of VAT rate and reduction of fiscal burden on labour though reduction of social contributions. Reduction of fiscal burden on labour and increase of taxes on consumption represent a so-called fiscal devaluation, by which the international price competitiveness of Serbia's economy is improved. Even though such a reform was proposed in Serbia a little over two years ago, the Government at the time could not reach a consensus on its implementation. However, it is estimated that implementation of this reform is still justified, confirmed by examples of quite a few countries that have implemented such a reform in the past two years or are getting ready to do it. Another important tax reform refers to property tax, where a large number of important changes need to be realised, such as: integration of land usage fees into property tax, harmonisation of tax basis with property's market value, increase of property scope that is being taxed, etc.

Abolishing of some tax reliefs and exemptions should primarily prevent the decline in revenue due to restructuring of the economy, and not increase the share of taxes in GDP. In case of VAT, it is justified to transfer some products in the coming years from lower to higher tax rate in order to have in the long term a unique VAT rate. In addition, it is justified to abolish tax reliefs and exemptions in profit taxes since the new tax rate will be competitive as well. From the standpoint of reduction of costs and risks in doing business, it is important to reduce the costs of tax compliance, which means simplifying tax procedures.

In addition to the stated structural reforms, it is necessary to have sectoral strategies that would encourage productivity growth in sectors that are estimated to have a relatively secure demand in the future – as is the case of agriculture. It is important that different elements of encouraging agriculture (resolving the issues of owner relations, subsidies, tax policy, inciting public investment, etc.) be mutually aligned with the aim of having a more productive agricultural production in the future.

7 Suitable methodological framework for legally defining procedures could be a network diagram showing all currently required procedures for obtaining a building permit. Based on this, procedures could be identified that are necessary or that could be combined or simplified, procedures that can be done simultaneously and those that have to be done successively (in order to avoid the vicious cycle – in order to get permit A you had to obtain permit B, and in order to get permit B you needed to obtain permit A). Each procedure would have a maximum duration determined in order to identify a critical road whose duration would have to be equal or less than the waiting period on building permits in other relevant countries, e.g. countries of Central Europe.

5. World economic trends and recovery of Serbian economy

Economic trends in Serbia as a small open economy are strongly dependent on the trends in its surroundings, primarily those of EU and CEFTA member countries. Most of Serbia's trade and capital flows are with these countries. Current recession and announced stagnation next year as well as highly uncertain long-term perspectives of eurozone and EU itself, are negatively influencing the recovery of Serbia's economy. Recession and stagnation in European economies has resulted in lower demand for Serbian products, as well as reduction in EU investments in Serbia. So what can Serbia do in order to minimise negative effects of EU stagnation/crisis on Serbia's economy?

In the short and medium term, price competitiveness of the economy, measured by real foreign exchange rate, represents a key instrument in improving foreign trade flows in Serbia. Therefore, a real depreciation of dinar is necessary in order to improve competitiveness of domestic products both on global and domestic market. Real depreciation of dinar, along with lowering domestic demand through fiscal consolidation, would boost exports and lower the imports, and improve the foreign trade balance of Serbia. The effectiveness of such a policy was demonstrated in the period 2010-2011 when Serbia's exports grew at a rate of over 20% even though global economy was in recession. Real depreciation of dinar partially offsets the fall of real GDP in countries that import products from Serbia. In order to improve long-term competitiveness, structural reforms are of great importance, but before they yield full results, Serbia could face a balance of payment crisis. In addition, if next year real appreciation of dinar would be realised it would greatly neutralise positive effects of fiscal consolidation on external deficit.

Regardless of the reduction of fiscal deficit and real depreciation of dinar, Serbia will continue to generate in the following years relatively high deficits in the current account balance. Given that Serbia's foreign debt amounts to more than 80% of GDP, it is important to keep its growth in the future as small as possible, which means financing a bigger part of the current account balance deficit through foreign direct investments. In the next few years, it will be important for FDIs to be 1.5-2 bn EUR annually in order to reduce the risk of balance of payment crisis. In the period of investment boom, the stated investments were relatively easily realised, but in the period of stagnation in investing countries, it will not be so simple. If Serbia fails to provide the stated inflow of investments, it will face a growing risk of balance of payment crisis, whose consequences would be highly negative: fall of already low GDP and rise of unemployment. The negative effects of balance of payment crisis would additionally increase due to a spontaneously high real depreciation of dinar, which would result in high losses for companies and euro-pegged economy such as Serbian, and the impossibility of repaying euro-pegged loans would hit hard the banking system.

At a time when foreign direct investments in the world are declining, the struggle to attract them becomes even more fierce. So far, Serbia has mostly relied in that struggle on the policy of generous subsidies, which presents the most expensive and also insufficiently effective way of attracting FDI. It is, therefore, necessary for Serbia to take radical steps in order to improve the business environment, so it wouldn't have to pay the foreign investors to come to Serbia. Significant improvement in Serbia's international ranking in competitiveness and advantages for doing business or its improved credit rating would be clear signals that the Government has succeeded in doing that.

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