



Republic of Serbia  
Fiscal Council

## **ASSESSMENT OF THE DRAFT 2013 BUDGET LAW**

Belgrade, 13 November 2012

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## **INTRODUCTORY REMARKS**

Pursuant to Article 92ž of the Budget System Law, the Fiscal Council is tasked to draft and submit the analysis of Draft Budget Law of the Republic of Serbia to the National Assembly. In line with this legal obligation, the Fiscal Council analysed the Draft 2013 Budget Law of the Republic of Serbia and hereby the assessment of the given document is submitted to the National Assembly.

## SUMMARY

**Planned deficit reduction to 3.6% of GDP in 2013 represents a good reversal in fiscal policy, but it is most likely that it will not be fully successful.** The Fiscal Council estimates that, with planned fiscal policy in 2013, state deficit will exceed the planned one (4.3% of GDP) by around RSD 25 billion, while there are certain risks to exceed it further. Furthermore, proclaimed settlement of the problem involving accumulated arrears will have an additional effect to state expenditure increase and thereby, to higher deficit. Bearing in mind all the above mentioned, fiscal deficit may even reach 5% of GDP, which is why we think it is necessary to prepare measures for deficit reduction and increase the control over budget expenditure significantly. We suggest several measures for fiscal deficit reduction. The most important and economically justified one is reduction of transfers to local self-government. So as to improve budget expenditure control, we propose defining and monitoring quarterly expenditure execution targets (especially procurement of goods and of services and subsidies) and conditional measures which would become effective automatically if quarterly targets are not achieved.

**A strong reduction in the government deficit is planned in 2013 – from 6.7% of GDP in 2012 to 3.6% of GDP (from around RSD 220 billion to RSD 132 billion).** The sharp deficit reduction is necessary in order to stop the almost uncontrolled public debt growth at the end of 2013. The public debt has doubled its share in GDP since 2008 (from 30% of GDP to 60% of GDP) and if a similar trend continues in 2013 as well, there will be a public debt crisis – macroeconomic instability, a decrease in GDP and a high increase in unemployment.

**The deficit reduction in the short term will be achieved primarily by increasing taxes and reducing the increase in pensions and public sector wages.** In October 2012, the general VAT rate was increased from 18% to 20%, and the excise duties on tobacco products and the personal income tax rate were increased. In addition to these measures, the increase in the corporate income tax from 10% to 15% will become effective in 2013. On the public expenditure side, the strongest austerity measure is the restriction of increase in public sector wages and pensions to 2% in October 2012 and 2% in April 2013. The tax increase and the real reduction of allocations for wages and pensions will ensure a deficit reduction by over RSD 100 billion in 2013.

**The achievement of the planned budget deficit in 2013 will also require a sharp reduction of the expenditure for the procurement of goods and services and for subsidies.** The tax increase and the restriction of increase in pensions and wages will not be sufficient to achieve the planned fiscal deficit in 2013 because – as one of the consequences of the rapid public debt increase – there will be a strong increase in allocations for interest payment in 2013. Thus, the interest expenditure will increase by more than RSD 25 billion in 2013 relative to 2012. For this reason, the planned deficit reduction in 2013 also requires sharp reduction in the expenditure for the procurement of goods and services and for subsidies. It is also worth reminding that such a high increase in allocations for interest additionally confirms the necessity of interrupting the public debt increase without delay, because the amount of interest paid has already exceeded the government allocation for the police, the military, as well as half the allocation for science and education.

**The Fiscal Council believes that the reduction of expenditure for the procurement of goods and services and for subsidies has not been prepared well enough.** The main mechanism for the reduction of expenditure for the procurement of goods and services, and

partly for subsidies, is the restriction of allowed expenditure of government authorities for these purposes. Although the Fiscal Council welcomes the adoption of the supporting measures provided for by the Government for this purpose (improvement of the control of expenditure of government authorities and abolishment of own revenue of budget beneficiaries), there is a noticeable lack of a clear plan with an explanation as to exactly which government functions and programs are abolished or significantly reduced and why. This plan is not only necessary for the credibility of the announced deficit reduction, but also in order to streamline public expenditures in an economically optimal manner – by reducing the ones that are least useful.

**Therefore, the Fiscal Council estimates that the government deficit could exceed the planned level by around RSD 25 billion (0.7% of GDP) in 2012.** Most of the planned deficit reduction will undoubtedly be achieved and this is due to structural measures relating to wages, pensions and taxes. We believe that the remainder of the anticipated savings is insufficiently well prepared and therefore more difficult to achieve. This will then result in an increase in the deficit relative to the plan and we estimate this increase at around RSD 25 billion. The consolidated deficit in 2013 would then amount to around 4.3% of GDP ( RSD 156 billion) instead of the planned 3.6% of GDP ( RSD 132 billion).

**The planned deficit reduction in 2013 will be realized primarily at the republican government level.** The republican budget is the largest part of the consolidated government budget and therefore the most important for pursuing the fiscal policy. The Draft Law on the Budget of the Republic of Serbia for 2013 stipulates that almost all of the needed fiscal adjustment is to be achieved at the level of the Republic, which will reduce its deficit from RSD 203.6 billion to RSD 121.9 billion. It is worth noting that, in addition to the republican budget, a reduction is planned of the deficit of local self-government units by RSD 8 billion and the deficit of the Roads of Serbia Public Enterprise by around RSD 2 billion in 2013, while the mandatory social insurance funds, in accordance with their statutory restrictions, are balanced both in 2012 and in 2013. Due to the key significance that the republican budget has for achieving fiscal targets in next year, but also due to the purpose of this document (we submit this Opinion to the National Assembly in the process of draft RS budget adoption), our analysis was mostly focused on the republican budget. Nevertheless, we dedicated special chapters in this Opinion to local self-governments and mandatory social insurance funds.

**The revenue of the republican budget in 2013 is planned in an optimistic manner but it is still likely to be collected due to inflation acceleration.** The Fiscal Council's analysis indicates that the public revenue increase in 2013 is basically overestimated, particularly in the corporate income tax and non-tax revenue items. However, the latest available data on inflation in September and expectations in the coming months indicate that it is very likely that inflation will be slightly higher than the one used for the preparation of the budget. Due to higher inflation than planned, the republican revenue will increase by around RSD 10 billion – approximately by as much as we previously estimated to be missing due to optimistic planning. Therefore, with a slightly changed structure in items, the planned total revenue of the republican budget in 2013 will most probably be reached.

**The expenditure will most likely be slightly higher than the planned – by around RSD 25 billion, according to our estimates.** We have already stated that we expect the envelope for the expenditure for the procurement of goods and services and for subsidies to be exceeded, because the measures for its reduction have not been prepared in sufficient detail. More specifically, in subsidies, we expect higher than planned allocations for subsidized liquidity loans, subsidies for support to foreign direct investments and probably also subsidies in

agriculture – in the total amount of RSD 5 to 10 billion. There is no possibility of analysis by individual programs in the expenditure for the procurement of goods and services (including other current expenditure), so we opted to analyze the measures provided for in 2013 and the objective circumstances that will lead to its decrease (elimination of one-off costs - elections, transfer of own revenue to the budget and definition of priorities and the system of announcement of commitments and costs). In addition, we estimate that the allocation for interest payments will be at least 5 billion higher than those planned in the budget. We estimate that the expenditure for the procurement of goods and services in 2013, as well as subsidies, will exceed the plan by RSD 5 to 10 billion. A possible increase in expenditure for social security from the republican budget by RSD 1 to 2 billion should also be added to all this, because a significant part of these allocations is indexed to inflation, which would most likely be higher than the one used in the preparation of the budget.

**There are additional risks of higher republican budget expenditure, and therefore also the deficit.** No funds are planned in next year's budget for the Smederevo Steel Mill, although significant budget funds were allocated for this company in 2012. If this company is not privatized soon, certain expenses that are not planned by the Draft Budget Law will probably appear for it in 2013 as well. Furthermore, there already are public announcements that the one-off "Thirteenth Pension Program" will become a permanent right. The Draft budget only provides for the payment of the remaining two installments from this program, and so its continuation would lead to an increase in the deficit. Still, certainly the most dangerous risk is that there will be problems in the implementation of the announced indexation of wages and pensions by 2% in April, because it is possible that inflation will be much higher than expected until just a month ago when the indexation agreement was made.

**It is particularly important to prevent the accumulation of new arrears by the government and resolve the problem of the existing ones.** The accumulation of arrears in government payments is dangerous in two ways – on the one hand, it endangers public finance, because, in the end, these outstanding liabilities most often become the public debt while, on the other hand, the government arrears increase the illiquidity of businesses, which do not receive funds for the product or service sold. In the past few years, there was a significant increase in government arrears, especially in health, local self-government and for the maintenance of road infrastructure. The total amount of these arrears reached more than 1% of GDP and now measures must be taken to solve this problem. A necessary prerequisite for this is to prevent the creation of new arrears in 2013 (and in subsequent years). The Fiscal Council therefore welcomes the announcement of a tighter restriction of payment periods, but also the introduction of additional measures for those budget beneficiaries in which we observed a systemic increase in arrears in the last few years (Republic Health Insurance Fund).

**The existing arrears should be paid in a fiscally responsible and transparent manner.** In terms of solving the problem of the existing arrears, we suggest the introduction of additional and specific rules:

1) We believe that a significant part of the burden of payment of the accumulated liabilities should be borne by those government authorities that accumulated the arrears in the first place. Unconditional financial rescue of certain government levels and budget beneficiaries by the Republic does not sanction their irresponsible management of their own finances and may lead to "moral hazard". So, in the case of local self-government units, we believe that the role of the republican government should not go beyond coordination and control, because now local self-government units have enough funds to deal with the problem of arrears by themselves. The

arrears in health care (Republic Health Insurance Fund and hospitals) would most probably require certain government intervention, which should then be limited in amount and clearly conditioned.

2) The financial volume of the total government intervention (and therefore the increase in public debt) should be restricted in 2013 to maximum 0.5% of GDP. This means that, with the above transfer of the part of the burden to those that made the arrears in the first place, it would be necessary to provide a discount of the existing liabilities and an optimal schedule of their payment through a negotiation process.

3) The payment of liabilities based on accumulated arrears should be included in the government deficit in 2013. The payment of debt based on arrears may be effected in two ways: by posting it “below the line” and without increasing the deficit, or by including it in the deficit. In both cases, the increase in the public debt would be identical. Since the goal of fiscal consolidation and deficit restriction in next year is to stop the public debt accumulation, we believe that it does not make much sense to increase the public debt based on borrowing for the payment of arrears and then not present this in the deficit. The inclusion of these payments in the budget increases the transparency of the whole process and we believe that it is economically correct.

**If the accumulated arrears are cleared in 2013, it will be even more important to keep the remaining government expenditure under control.** Based on the payment of arrears in 2013, the deficit could increase to around 4% of GDP. Otherwise, the deficit in 2013 could exceed 5 % of GDP, which we consider to be fiscally unsustainable. In addition to previously identified other risks and overly optimistic planning of certain expenditures, it is very possible that the fiscal deficit in 2013. and reached 5% of GDP. Therefore, it is especially important to keep the remaining public expenditure under control and not allow it to exceed the envelope in which it is planned.

**Therefore, the Fiscal Council proposes additional measures in order to keep the deficit within the planned limits.** We propose the following: 1) Reduction of transfers to local self-government units. The 2011 legal amendments provided local self-government units with around RSD 40 billion of additional funds at the expense of republican revenue. Having this in mind, it is surprising that additional transfers to local self-government units are approved from the republican level in 2013, in addition to the standard ones, this time for the maintenance of road infrastructure (in the amount of RSD 4 billion). The Fiscal Council believes that this additional transfer should be abolished immediately and then the amount of other, non-categorical transfers to local levels should be reviewed and reduced by around RSD 7 billion. 2) Review and abolishment of certain wasteful subsidy programs. The 2013 Draft Budget provides for a significant increase in subsidies for housing construction, commodity loans for Republika Srpska (computers, railway cars) and alike, and new programs are introduced (shipbuilding). We believe that it is necessary to review the justification of all these subsidies, select priorities and thus reduce the expenditure for subsidies and total public expenditure. 3) We believe that the unjustified payment of wage benefits to the employees in the Ministry of Internal Affairs, which is treated as welfare benefit for employees, should be reviewed or at least significantly reduced. RSD 7 billion is planned for these purposes in 2013 (of which, in our opinion, RSD 6.5 billion is unjustified).

**Possible savings on capital expenditure would not be in accordance with good practice in public finance management.** A reduction of the share of capital expenditure in GDP is planned already in next year, which we do not find appropriate for the level of economic

development and the economic cycle in which Serbia is. We emphasize, however, that in the previous years, when a need arose for making savings during the year, they were found in reducing capital expenditure. Since already now there are risks of departure from the planned fiscal envelope, the opinion of the Fiscal Council is that it should by no means be allowed for the increase in current expenditure to be achieved at the expense of capital expenditure.

**The Fiscal Council believes it is necessary to introduce additional control mechanisms for budget implementation.** The Fiscal Council thinks extra guarantees are needed to prove that the Government will comply with the planned expenditure scale, i.e. no state body will increase their expenditure above their limits during the year – which used to be bad practice in the past. To that end, we consider it necessary to define and adopt quarterly expenditure execution targets. However, we would like to stress that, for sure, the best guarantee for fiscal plans credibility for next year would be a new arrangement with the IMF.

**We suggest the definition of quarterly expenditure execution targets.** Our analysis has shown that the risk of exceeding the planned fiscal envelope in 2013 is much higher on the budget expenditure side than on the revenue side. Therefore, we believe that the control of expenditure execution during the year and a timely prevention of its increase beyond the planned envelope will be of crucial importance in next year. To this end, we suggest that the Government define quarterly execution targets for total expenditure of the Republic budget, but also for the expenditure with a particularly high risk of exceeding the planned budget envelope – such as the expenditure for the procurement of goods and services and the expenditure for subsidies. We also believe that the position of government arrears should be included in the proposed quarterly budget execution targets in 2013 – so that the data on the arrears trend in 2013 would be visible and better controlled. We also suggest that the quarterly targets be agreed upon with the Fiscal Council, as well as that the Fiscal Council monitor their achievement and inform the public about it.

**In case the quarterly targets are not achieved, we suggest defining the conditional measures that would automatically take effect.** We consider it desirable also to define in advance the measures that would automatically take effect if the defined quarterly targets are breached. The conditional measures would bring additional credibility to the budget expenditure restriction. These measures could relate to the indexation of pensions and wages in October, the suspension of some subsidy programs or something else.

## 1. MACROECONOMIC PROJECTIONS AND BUDGET DEFICIT IN 2013

**The Fiscal Council believes that it is possible for the economic growth to be somewhat lower and for inflation to be somewhat higher than the one used in the preparation of the budget.** The latest available data indicate somewhat less favorable trends in the economic activity and acceleration of inflation in the second half of 2012. For this reason, in next year it is likely that somewhat lower growth – of around 1.4% – will be achieved instead of the economic growth of 2% and that the average inflation will be around 1.5 percentage points (pps) higher than the planned.

**The total impact of change in the macroeconomic environment (GDP and inflation) on the planned deficit will be positive in 2013 – it will act towards deficit reduction.** On the public revenue side – a somewhat slower economic growth will only cause a minor reduction of public revenue relative to the plan, while the revenue will be increased much more by higher than planned inflation. In the aggregate, these two factors will cause an increase in public revenue. On the public expenditure side, there will be a slight increase in public expenditure because of inflation acceleration. Some government allocations, such as certain social benefits, are indexed to inflation<sup>1</sup>, and higher inflation will increase the pressure to increase the restrictively planned expenditure for the procurement of goods and services. There may also be risks of failure to implement consistently, due to higher inflation, the planned indexation of wages and pensions in April 2013, which was defined at 2% in nominal amount – regardless of price trends. Taking all effects together, we believe that the possible changes in the macroeconomic environment will have a moderately positive impact on the budget and that they will cause the deficit to decrease.

**It is likely that the economic growth will be around 1.4% in 2013, although, due to many unknowns, we still do not rule out the possibility of achieving higher economic growth, either.** We reached the above estimate by analyzing GDP by application, but also taking into account the latest published data of the RSO (a flash estimate of GDP for the third quarter of 2012). We estimate that the growth in 2013 will be driven by the growth in net exports, while the private and government spending will record a decline. In addition to these estimates, we expect an approximately unchanged level of investment and solid growth of stocks.<sup>2</sup> We estimated 1.4% growth, without taking into account a possible recovery of production in the Smederevo Steel Mill and only counting on a moderate recovery in agricultural production next year. Therefore, it is possible that the 2% growth forecast will still be achieved with the help of some exogenous factors. We also note that the incomplete and, as it turned out, often unreliable data published by the Republican Statistical Office (RSO) are a major difficulty in forecasting GDP. Significant data revisions and corrections take place almost regularly during the year, and there were also revisions of GDP data even for several previous years. We should also add to all this that still no official data on GDP application at the quarterly level is published in Serbia. Without data of sufficient quality, fiscal policy implementation in Serbia is harder than in most other European

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<sup>1</sup> Pensions and wages in the public sector will also be indexed to inflation from October, but the latest acceleration of inflation will have no impact on the planned indexation in October.

<sup>2</sup> In this analysis, reserves were perceived separately from investments due to the specificity of a change expected in 2013 reserves (since there is expected increase in agricultural production scale).

countries, and the forecasts and projections of both the Fiscal Council and the Ministry of Finance are then much less reliable.

**The economic growth decrease will not have a major impact on the change in public revenue in 2013.** The difference between the projections of the Fiscal Council and the Ministry of Finance is mostly in the estimate of investment trends in 2013, while the projections do not differ in terms of expectations regarding the spending trend – which is the most abundant in terms of taxes. Therefore, the difference in the economic growth forecast does not have a significant impact on the public revenue estimate of the Fiscal Council and the Ministry of Finance.

**Net exports are likely to increase by around 12% in 2013 relative to 2012.** A number of different factors will have an impact on the net exports trend next year. Positive impact will come from the operation of the FIAT Automobiles Serbia Company, which we expect to contribute to the net exports growth in 2013 with around EUR 550 to 600 million.<sup>3</sup> On the other hand, next year we expect a decrease in the exports of agricultural and probably food products due to extremely poor agricultural crop of 2012. The operation of the Smederevo Steel Mill in 2013 is still totally unpredictable, although we emphasize that this company, in spite of being a potential large exporter, is a large importer at the same time – because of which its contribution to net exports is not as large as would be suggested solely by the data on exports.<sup>4</sup> The exports of other goods and services will slightly increase as the economy of the EU and the neighboring countries gradually recovers. On the other hand, the imports will slightly decelerate their growth also as a consequence of the expected reduction in government and private spending in 2013. Taking all this into account, it is our estimate that the net exports in 2013 will record a relatively high increase of around 12%, contributing with around 2.4 percentage points to the overall GDP growth. The exports in 2013 would have undoubtedly increased further if the dinar strengthening in the second half of 2012 had not almost annulled the effect of the real depreciation from the first half of the year. Any further strengthening of the dinar value would decrease the competitiveness of Serbian exports, while imported goods would become more competitive, so the strong dinar would thus directly cause the weakening of domestic production.

**We anticipate that private spending will record a real decrease of around 1.5% in 2013.** Private spending is mostly funded from wages and pensions, so a forecast of trends in these two factors may approximate most of the domestic demand trends. The trend in pensions and public sector wages may be reliably estimated from the planned government expenditure for next year, whereas we assumed a smaller real decrease in wages (1%) for the trend in the wage bill in the private sector due to further employment decrease and the approximately unchanged real amount of average wage.<sup>5</sup> Regarding the remaining sources of the private spending funding, we analyzed the trend in consumer loans and remittances as well. Taking all this into account, we anticipate that private spending in 2013 will record a real decrease of around 1.5%, which will contribute to the decrease in the overall economy with around 1.2 pps.

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<sup>3</sup> Net exports exclude the imported components needed for car manufacture. In our calculation, we used an estimate that this company will manufacture around 90,000 cars more next year than in 2012.

<sup>4</sup> This company was the largest exporter in Serbia for many years.

<sup>5</sup> The average non-public sector wage recorded a real increase of around 3.5% in the first 9 months of 2012, but we expect a decrease in real wages until the end of the year and in 2013 as a consequence of sharp inflation acceleration, so the estimate of the trend in the wage bill in the private sector in 2013 is probably slightly optimistic.

**Government spending will post a decrease of around 4.5% due to strong fiscal adjustment of the deficit.**<sup>6</sup> The beginning of fiscal consolidation and a large reduction of fiscal deficit in 2013 will cause a reduction of government spending in 2013. Due to limited wage indexation in October 2012 and April 2013 and restrictive planning of the expenditure for the procurement of goods and services, government spending in 2013 will record a real decrease of around 4.5%.<sup>7</sup> This decrease will contribute to the decrease in the overall economy with 0.8 pp.

**The Fiscal Council does not expect any real investment growth in 2013.** The forecast weak recovery of the EU, the decelerated economic and credit activity in Serbia and the planned real reduction of public capital expenditure in 2013 do not indicate any investment growth in next year. A somewhat more detailed investment analysis requires observation of their trend not only in 2012, but also in several previous years. Namely, a significant decrease in investment (most probably by around 10%) will be recorded in 2012. This, however, does not mean that the investment level in 2012 is unusually and temporarily low (like, e.g., in agricultural production in 2012), so that therefore an increase in investment should be expected in 2013. In fact, the significant real decrease in investment in 2012 occurred primarily because of comparison with 2011, when investment was unusually high (FIAT, NIS and other) and recorded a real increase of more than 20%. Therefore, the result in 2012 is actually above the multiyear average, so we believe that investment will be at the same level in 2013 as well, and that its real increase will be around 0%. Still, the possibility for investment to increase next year should not be excluded, but it could happen primarily if several larger investments materialize rather than as a result of a large number of small and medium-sized investments. For example, it is possible that the privatization of the Smederevo Steel Mill will initiate a new investment cycle in this company.

**We expect an increase in stocks of around 1% of GDP in 2013.** The extremely poor agricultural season as a consequence of drought in 2012 (a decrease of around 20%) will most likely cause a strong increase in agricultural production in late 2013, even if 2013 is an average agricultural year. Therefore, we expect that this increase in agriculture will cause a significant increase in stocks at the end of 2013 - which represents an increase of GDP by the same amount (1 pp).

**We reached a similar estimate of GDP growth of around 1% in 2013 by analyzing the trend in seasonally adjusted GDP indices as well.** Namely, the latest data indicate that a significant decrease in production will be recorded in the second half of 2012. Preliminary data indicate that a 2.2% year-on-year decrease was recorded in the third quarter relative to the previous year as well as a seasonally adjusted decrease of as much as 1.5% relative to the second quarter. Therefore, the real economic activity decrease in 2012 will probably be close to 2%.

**The drop shifted from 2012 will give rise to a situation when GDP growth in 2013 will not reach a high level even in case of solid economic recovery.** Chart 1 shows a possible trend in seasonally-adjusted GDP in 2013. The assumptions used for the projection are: 1) that the decrease in the economy from the third quarter ends in the fourth quarter, and then 2) that an economic recovery similar to that after the first crisis wave (in 2009) starts from the beginning of 2013. Such a GDP recovery path would result in growth rate of around 1%, which is quite similar to the estimated growth of 1.4%. The Fiscal Council believes that the shown production recovery path is realistic. Finally, it is worth noting that this type of analysis is very sensitive to

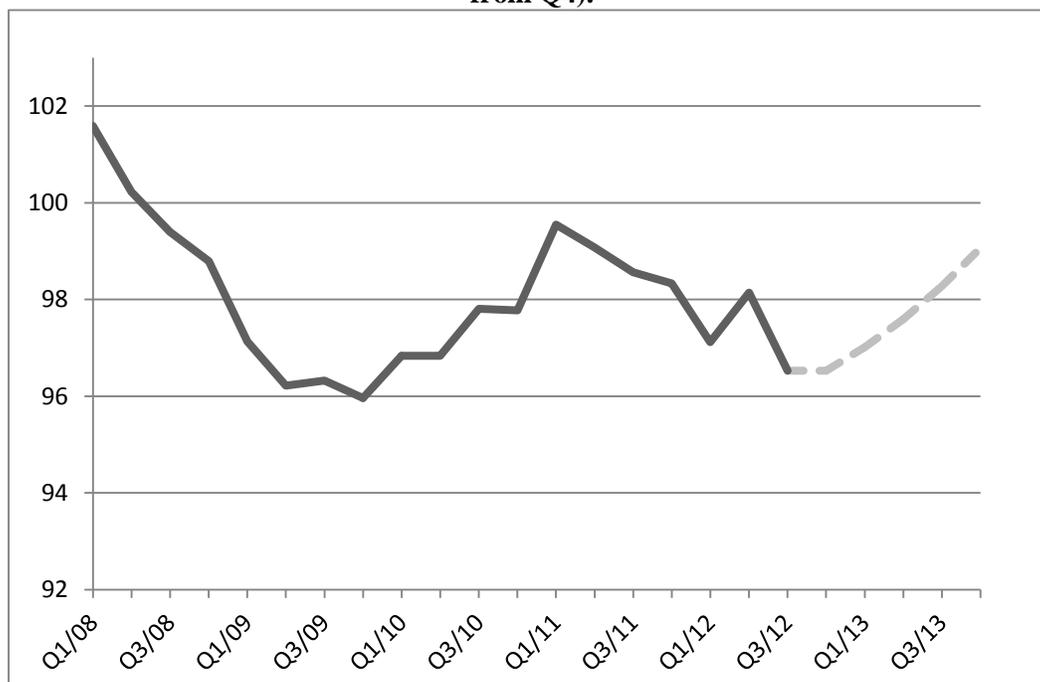
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<sup>6</sup> Inflation rise was included in the projection. But, on the other hand, the estimated expenditure growth due to accumulated arrears was included as well.

<sup>7</sup> We have already included in this forecast a slightly higher inflation but also a slightly higher government spending than planned.

GDP data revisions, which is why we use it only as a further confirmation of the previously estimated growth.

**Chart 1: The seasonally-adjusted GDP trend (RSO data until Q3 2012, Fiscal Council projections from Q4).**



Source: Fiscal Council estimate based on the RSO data

**Inflation would probably be somewhat higher than planned – by around 2 percentage points already at the end of 2012.** There was a strong increase in inflation by 2.3% in September, because of which the price increase will be somewhat higher at the end of 2012 than the planned 11% and will most likely be around 13%. The reasons for the high acceleration of inflation in 2012 are the high increase in food prices, the exchange rate depreciation in the first half of the year, but also a great expansion of government spending. The higher inflation in 2012 will also be contributed to by the tax increase in October (VAT, excise duties). Because of the higher inflation than planned, we expect somewhat higher public revenue already in 2012.

**We expect average inflation of around 11.6% in 2013.** The increase in inflation from the end of 2012 will be directly transferred to the beginning of 2013 and thus cause higher average inflation in next year. Inflation will increase on this basis alone by around 1 pp relative to the plan with which the budget was prepared. The Fiscal Council expects the average inflation in 2013 (which is relevant to budget planning) to increase by around 1.5% relative to the 10,1 hc% planned.<sup>8</sup>

**The increase in inflation will cause a decrease in the fiscal deficit.** The largest government expenditure (pensions and wages) in 2013 should not depend much on the inflation trend.

<sup>8</sup> We also included the risks that inflation will be slightly higher than 13% at the end of 2012, but also that the 5.5% target of total inflation in 2013 will not be reached.

Namely, a 2% nominal indexation of pensions and wages in the public sector in April is planned – regardless of the inflation trend. On the other hand, higher inflation will cause higher public revenue than planned but, since it will not be followed to the same extent by the increase in expenditure, the deficit will decrease.

**The improvement of the government’s fiscal position with the acceleration of inflation has a limited reach and carries serious risks.** The increase in inflation will cause an increase in certain expenditure in addition to the increase in tax revenue. There are certain government allocations that are automatically indexed to higher inflation, and higher inflation will certainly exert pressure towards exceeding the planned expenditure for the procurement of goods and services. The problems in implementing the planned, relatively low indexation of pensions and wages in April (and maybe in October as well), which is one of the foundations of fiscal consolidation, may be the most dangerous.

**Higher inflation will reduce economic growth as well.** The structure of the estimated economic growth in 2013 indicates that a higher inflation would have a negative impact on the economic activity. Namely, government spending is generally defined in nominal terms so the contribution of this component (G) to the GDP growth achieved, with a 1 pp increase in inflation, would be around 0.15 percentage points lower. The contribution of private spending (C) to the economic growth would also decrease by a similar or somewhat higher amount.<sup>9</sup> However, these decreases in spending would directly cause a decrease in imports and an improvement of the net exports component (X-M).<sup>10</sup> As a combination of all these effects, it is clear that the expected increase in inflation in 2013 will cause a certain decrease in GDP.

**We estimate that a one per cent increase in inflation cannot bring more than 0.5 percentage points of increase in public revenue, and maybe even less than that.** As we have already shown, the spending leading to high tax revenues will decrease in real terms with higher inflation in 2013 (which is partly compensated by somewhat higher net exports, but the positive impact of net exports increase on public revenue is not as high as the negative impact of lower spending). Higher inflation will cause an increase in certain public expenditure as well. Therefore, we believe that the increase in inflation, as a way of improving the fiscal position of Serbia, has a number of negative effects – in addition to the increase in revenue, certain expenditure increases as well, while the macroeconomic stability is disrupted. Therefore, our conclusion for the entire chapter is as follows: the change in the macroeconomic environment relative to the plan, which will probably happen, may have a limited positive impact on the fiscal deficit, but most probably will not provide crucial contribution to achieving the planned fiscal targets.

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<sup>9</sup> The sources of funding the spending (pensions, government sector wages and, probably slightly less, private sector wages) would decrease more in real terms.

<sup>10</sup> Such an analysis also provides an implicit answer to the question whether higher government spending may significantly boost the economic growth in Serbia. The answer appears to be generally negative, because higher consumption translates into a decrease in net exports (an increase in imports). We had a similar episode in 2012, when the strong increase in government spending did not prevent the economy from getting into recession, while the trade imbalance increased considerably.

## 2. CONSOLIDATED GOVERNMENT ACCOUNT IN 2013

**In 2013, a planned deficit of a consolidated state will reach RSD 132 billion (3.6% of GDP), which stands for a significant reduction in comparison to 2012 level.** 2012 deficit will amount to around 6.7% of GDP (RSD 220 billion) and therefore, one can conclude that the reduction planned for 2013 is extremely strong. The main measures which will lead to such reduction are tax increase (VAT, excises, income tax and profit tax) and limitation of public sector pensions and wages indexation to 2% in October 2012 and in April 2013.

**The Fiscal Council estimates that the deficit is still most likely to be somewhat higher than the planned one – by around RSD 25 billion.** Partly due to higher inflation, we think it is likely to see tax revenues similar to those planned for 2013 (slightly lower). However, we believe that it will be very difficult to implement the plan for public expenditure decrease. It is most likely that the planned 2013 fiscal deficit limit will be overstepped in terms of procurement of goods and services, subsidies and interest rates – by RSD 20-25 billion.

**A significant increase in public revenue is expected in 2013 as a consequence of increase in statutory tax rates.** The general VAT rate was increased from 18% to 20%, the corporate income tax will be increased from 10% to 15%, the personal tax on income from (financial) capital was also increased from 10% to 15%, and the amounts of excise duties on tobacco products and some oil products increased as well. On the other hand, the partial abolishment and restriction of quasi-fiscal charges at the republican and local level as well as the changes in the structure of operation of the VAT system will cause a certain loss of revenue next year. In aggregate, a net increase in revenue of around RSD 45 billion in 2013 is expected as a consequence of the amendments to tax laws.

**The Fiscal Council estimates that, relative to the assumed macroeconomic trends, the public revenue is optimistically planned in the amount of around RSD 10 billion.** Considering that public revenue depends on the materialization of a large number of macroeconomic variables whose trend is hard to predict, it is generally impossible to budget the level of public revenue with certainty. This uncertainty is particularly pronounced in next year, because the possible band within which the rate of GDP growth will move is relatively high (see the macroeconomic projections). Therefore, it is important to budget next year's public revenue in such a way that the probabilities that the collected revenue will be higher than the budgeted and that the collected revenue will be lower than the budgeted – are equal.<sup>11</sup> Relative to the macroeconomic assumptions used in the preparation of the 2013 budget, the Fiscal Council estimates that it is more likely for the collected revenue to be lower than the budgeted than higher than the budgeted and that the revenue is optimistically budgeted, approximately in the amount of RSD 10 billion.

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<sup>11</sup> In fact, a conservative projection of public revenue could be required from a prudent budget process so that it is more probable that the collected revenue will be higher than the budgeted revenue in order to ensure, with as high a level of certainty as possible, enough available funds to execute the budget expenditure according to the plan.

**Table 1. Consolidated general government revenue in 2013, RSD billion**

	Ministry of Finance and Economy	Fiscal Council, with MoF macro assumptions	Fiscal Council, with own macro assumptions
<b>TOTAL REVENUE</b>	<b>1,613.7</b>	<b>1,600.0</b>	<b>1,611.0</b>
<b>Tax revenue</b>	<b>1,412.4</b>	<b>1,403.0</b>	<b>1,413.0</b>
PIT	182.9	184.0	185.0
Contributions	415.6	416.0	417.0
CIT	79.1	74.0	74.0
VAT	429.0	426.0	432.0
Excise duties	224.8	224.0	225.0
Customs duties	33.1	33.0	34.0
Other tax revenue	47.9	46.0	46.0
<b>Non-tax revenue</b>	<b>199.3</b>	<b>195.0</b>	<b>196.0</b>
<b>Donations and capital revenue</b>	<b>2.0</b>	<b>2.0</b>	<b>2.0</b>
<b>TOTAL EXPENDITURE</b>	<b>1,746.0</b>	<b>1,763.7</b>	<b>1,767.2</b>
<b>Current expenditure</b>	<b>1,594.4</b>	<b>1,612.2</b>	<b>1,615.7</b>
Employee expenditure	406.3	406.3	406.3
Procurement of goods and services	258.9	262.2	263.7
Interest repayment	95.5	100.5	100.5
Subsidies	109.2	116.7	116.7
Social benefits and transfers	691.2	691.2	692.7
<i>of which pensions</i>	500.7	500.7	500.7
Other current expenditure	33.3	35.3	35.8
<b>Capital expenditure</b>	<b>139.3</b>	<b>139.3</b>	<b>139.3</b>
<b>Outlays for procurement of financial assets</b>	<b>12.2</b>	<b>12.2</b>	<b>12.2</b>
<b>CONSOLIDATED GENERAL GOVERNMENT DEFICIT</b>	<b>-132.3</b>	<b>-163.7</b>	<b>-156.2</b>
<b>CONSOLIDATED DEFICIT (% GDP)</b>	<b>-3.6</b>	<b>-4.5</b>	<b>-4.3</b>
<i>Memorandum item: Year-on-year inflation</i>	10.10%	10.10%	11.60%
<i>Memorandum item: Real GDP growth</i>	2%	2%	1%

Source: Ministry of Finance and Economy, Fiscal Council

**However, the acceleration of inflation during the autumn of this year will make it possible for the budgeted revenue to be really collected for the most part in 2013.** The acceleration of inflation during September and October will cause the year-on-year inflation rate in 2013 to be somewhat higher than the amount assumed in the preparation of the budget. Faster

inflation will cause a (nominal) increase in public revenue, the consumption tax before all, by around RSD 10 billion. Hence, we expect that the amount of collected public revenue in 2013 will be very close to the budgeted amount of revenue.

**Public expenditure will significantly decrease in real terms in 2013 – primarily due to the restricted indexation of pensions and wages.** A significant tightening of fiscal policy and a very ambitious reduction of public expenditure of around 5.5% in real terms are planned in 2013. Tough and systematic measures in the expenditure account were necessary in order to achieve this plan. The most important of these measures is the restriction of indexation of wages and pensions to 2% in October 2012 and 2% in April 2013. We estimate that the savings on the basis of lower indexation of pensions and public sector wages than inflation will be as much as RSD 55 billion in 2013. Namely, inflation accelerated to 7.2% in the period April-September 2012, so the wages and pensions in October would have increased by 7.2% if there had been no restriction of indexation to 2%. Therefore, savings in wages and pensions of more than 5% have already been achieved now (which will decrease the expenditure for pensions and wages by around RSD 40 billion in 2013). The other part of savings will be achieved from April 2012, because we expect inflation to be higher than the planned indexation (2%) in the period October 2012-April 2013. Taking all this into account, we estimate savings on the basis of lower indexation of pensions and wages to around RSD 55 billion in 2013. As for the other Government measures, it is planned to make savings of around RSD 20 billion on the basis of rational planning of expenditure after the abolishment of own revenue of government authorities, which the Fiscal Council considers to be optimistically estimated and believes that the highest possible outcome of this measure in 2013 is around RSD 10 billion.

**The Fiscal Council's analysis indicates that the public expenditure will most likely still exceed the planned level by RSD 15-20 billion.** We believe that the expenditure for the procurement of goods and services, as well as the planned subsidies are overly optimistic and that the increase in expenditure will be additionally caused by higher inflation than the planned. Therefore, we estimate that the public expenditure in 2013 will most likely be RSD 15 to 20 billion higher than the planned.

**In addition to the planned fiscal consolidation measures, acceleration of inflation will additionally decrease the deficit.** The largest expenditure items of the budget (pensions and wages) are defined almost completely in nominal terms for next year, so the increase in inflation does not have a major impact on these allocations.<sup>12</sup> Therefore, the acceleration of inflation will lead to a higher increase in public revenue than in public expenditure – i.e. the deficit will decrease with higher inflation in 2013 (Table 1). By way of illustration, if there had been no acceleration of inflation, the savings in allocations for wages and pensions would have been around RSD 40 billion, while in this way they are as high as RSD 60 billion. From an economic perspective, this means that, because of higher inflation, the real decrease in pensions and wages will be around 8.5% rather than around 6% as we previously expected.

**The deficit reduction in 2013 will mainly be achieved, but the Fiscal Council estimates that savings of around 0.7% of GDP are still missing to fully achieve the target (a deficit of 3.6% of GDP).** We estimate that the deficit in 2012 would be around 4.3% of GDP without

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<sup>12</sup> The planned indexation in October is linked to the price increase in the period April-December 2013, but it will not have much impact on the expenditure for pensions and wages in 2013. In the first place, this indexation will only affect the wages paid in November and December, and we also expect that inflation will significantly decelerate after April, so that it will not differ considerably from the projections with which the budget was prepared.

additional austerity measures. It is possible for the departure from the plan by 0.5% of GDP (around RSD 25 billion) to be compensated by additional and, we believe, justified austerity measures, such as the reduction of transfers to local self-government units, abolition of certain subsidies and reduction of unjustified wage benefits. We believe that the worst solution would be the solution often used in the previous years - achieving additional savings during the year by reducing public investment.

**Due to the risks existing on the expenditure side, the Fiscal Council suggests defining quarterly targets, whose monitoring would enable a timely response if the expenditure increases above the planned level.** This would ensure that the expenditure, and therefore the deficit, remains within the projected limits. Otherwise, in the event of any breach of quarterly targets, the established mechanisms would be activated with the aim of bringing the expenditure and deficit back to the path specified by the Draft 2013 Budget Law. We suggest that by the end of the year the Ministry of Finance and Economy propose target quarterly expenditure for 2013 and the measures that would be implemented if the expenditure goes beyond the planned limits. The agreed quarterly targets and the stabilization measures agreed between the MFE and the Fiscal Council would be part of the Memorandum on Sustainable Path of Expenditure and Deficit for 2013 that these two institutions would sign by the end of 2012.

**The quarterly targets would measure total expenditure, subsidies and the expenditure for goods and services, at the central, as well as lower government levels.** The Fiscal Council suggests defining a few (four to five) precisely determined fiscal targets for each of the quarters in 2013, so that their fulfillment or non-fulfillment would be easy to determine. At the end of each quarter, the execution of different categories of expenditure would be compared with the targets defined. If, at the end of the quarter, the execution is higher than the planned targets by an amount defined in advance (e.g. if it is higher by 5% or 10%), measures would be conducted that should ensure the reduction of total expenditure. The first target would be the amount of total expenditure, the second would be the amount of expenditure for goods and services, and the third would be the amount of subsidies. In addition to these, it is possible to define additional targets at the republican and/or local level. It is also possible to define two levels of quarterly targets, one for the republican level and the fund level, and other for the local self-government level. The reason for this is that the data on the amount of expenditure at the local self-government level is received a month later than the republican level data.

**The establishment of indicators for quarterly monitoring of the budget expenditure execution in 2013 and the measures that would be implemented if the expenditure were higher than the planned would contribute to additional credibility of the fiscal consolidation program.** The Fiscal Council, as explained earlier, believes that the budget expenditure will be RSD 20-25 billion higher in 2013. In addition, there are certain risks that the expenditure will exceed this level as well, which would jeopardize the entire program of fiscal consolidation in 2013, as well as in the following years. Therefore, monitoring the trend in expenditure and timely response present one of the basic elements of the program credibility.

### 3. ASSESSMENT OF THE DRAFT BUDGET LAW FOR 2013

#### *3.1. Assessment of the effects of amendments to tax regulations on the budget revenue in 2013*

**The adopted and planned amendments to tax regulations will allow an increase in the revenue of the Republic budget by around RSD 50 billion in 2013.** The adopted amendments to tax laws in September include the Law on Value Added Tax, the Law on Personal Income Tax and the Law on Excise Duties, the abolishment of a number of quasi-fiscal charges at the republican level, while amendments to the Law on Corporate Income Tax are announced as well for the end of this year.

**The adopted amendments to the Law on Value Added Tax will allow an increase in budget revenue by around RSD 21 billion.** The adopted amendments include an increase in the general VAT rate from 18% to 20%, as well as certain structural changes in the operation of the VAT system – the possibility of paying the VAT upon collection for small and medium-sized enterprises, raising the threshold for (mandatory) inclusion in the VAT system, raising the annual turnover limit for quarterly settlement of tax liabilities, increasing the amount of compensation to farmers outside the VAT system from 5% to 8%, as well as the possibility of partial reimbursement (under certain conditions) of the VAT on baby products.<sup>13</sup> Raising the general rate from 18% to 20% will allow an increase in tax revenue by around RSD 34 billion next year, but the above structural changes will create a loss of revenue of around RSD 13 billion, which gives a net increase in the budget revenue of around RSD 21 billion in total. Although the Fiscal Council, from the point of view of good tax policy, supports raising the threshold for inclusion in the VAT system from RSD 4 to 8 million of annual turnover, this measure will cause a budget revenue shortfall of around RSD 5 billion in 2013. In addition, increasing the amount of compensation for farmers outside the VAT system will produce a shortfall of RSD 3 to 4 billion next year, while the partial reimbursement of the baby VAT could cause a revenue shortfall of RSD 1 billion. Allowing a larger number of small and medium-sized enterprises to settle their liabilities quarterly instead of monthly, as well as allowing these taxpayers to pay their tax liabilities upon the collection of their receivables will cause a (one-off) loss of revenue of around RSD 3 billion – with this projection assuming that the Tax Administration will manage to prevent abuse and evasion within the system of collection of VAT liabilities upon the collection of receivables.

**The adopted amendments to the Law on Personal Income Tax will increase budget revenue by around RSD 6 billion next year.** These amendments increased the rate of tax on income from (financial) capital from 10% to 15%. This will allow an increase in budget revenue on the basis of income from dividends and shares in profits, interest income, taxable income from insurance, as well as on the basis of income from capital gain.

**Amendments to the Law on Excise Duties will allow an increase in budget revenue by RSD 7 to 8 billion next year.** The most important amendments include effective “freezing” of the amount of excise duty on petrol during 2013, increasing the excise duty on diesel and liquefied petroleum gas, as well as an effective increase in the excise duty on tobacco products – the fixed part of this excise duty increased to RSD 43 per pack, while the proportional part decreased from 34% to 33% of the retail price. In addition, the method of calculating the excise

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<sup>13</sup> For more details on the amendments to the Law on Value Added Tax, as well as on the amendments to the Law on Excise Duties, see the Fiscal Council report of 13 September 2012.

duty on coffee was changed by shifting, in accordance with the European practice, from proportional calculation to fixed amount of excise duty on coffee.

**The announced changes in the corporate income tax will allow an increase in budget revenue by RSD 21 to 22 billion in 2013.** The Ministry of Finance and Economy announced that the corporate income tax would be increased from 10% to 15% by the end of the year, while most of the tax reliefs and exemptions (which did not prove to be productive) would be abolished. Increasing the tax rate from 10% to 15% will increase the revenue by around RSD 21 billion next year. However, given the long-term character of (major) tax exemptions, as well as the uncertainty whether the most generous tax credit for investment in fixed assets will be abolished or reduced at all – we expect no additional revenue on this basis in 2013.

**The abolishment of certain quasi-fiscal charges will cause a loss of around RSD 5 billion revenue in the budget of the Republic in 2013.** The legal amendments in September this year abolished or restricted certain republican administrative fees, the forest fee, as well as the budget fee on tobacco, whose funds had been used for the special purpose of improving health insurance. We estimate that the total loss of non-tax revenue of the republican budget on this basis will be around RSD 5 billion.

### *3.2. Analysis of the planned revenue of the budget of the Republic in 2013*

**The Fiscal Council expects that the planned revenue of the budget of the Republic in 2013 will mostly be collected due to, inter alia, a higher rate of inflation than the budgeted.** As mentioned earlier, a higher rate of inflation will allow a (nominal) increase in public revenue, primarily the revenue from the VAT and the consumption tax, which will allow the revenue collected in 2013 to be very close to the budgeted amount of RSD 956 billion. However, although we expect that the total amount of budget revenue will mainly be collected, it seems certain that the revenue from the corporate income tax will not be collected in the amount budgeted, while we see high risks in the collection of non-tax revenue.

**It is not realistic to expect that the budgeted revenue on the basis of the corporate income tax will be collected.** As mentioned, the expected increase in the corporate income tax rate from 10% to 15% will allow an increase in budget revenue by around RSD 21 billion next year. However, it is necessary to bear in mind that the revenue from the corporate income tax in 2012, which is expected to be more than RSD 54 billion, is not an adequate basis for projecting the revenue for next year. Namely, significant one-off funds were collected from the corporate income tax this year, which include one-off (accounting) profit of some public enterprises or the tax on the sale of the *Maxi* Company. Hence, the corporate income tax revenue was extraordinarily high this year (one-time), which is not realistic to expect in 2013. In addition, unlike in 2011, this year we had an economic recession and a nominal depreciation of the dinar, which will have a negative impact on the profitability of enterprises when preparing their annual statements and filing tax returns for 2012. Considering that the profitability of enterprises during 2012 will crucially determine the level of the corporate income tax revenue that will be collected during 2013 – not even a more favorable trend in the macroeconomic aggregates during next year can help achieve the budgeted amount from the corporate income tax.

**Table 2. Revenue of the budget of the Republic in 2013, RSD billion**

	Ministry of Finance	Fiscal Council, with MoF macro assumptions	Fiscal Council, with own macro assumptions
PIT	53.5	54.0	55.0
CIT	70.4	66.0	66.0
VAT	429.0	426.0	432.0
Excise duties	224.8	224.0	225.0
Customs duties	33.1	33.0	34.0
Other tax revenue	8.0	8.0	8.0
Non-tax revenue	136.4	132.0	133.0
Donations and capital revenue	1.2	1.2	1.2
<b>TOTAL</b>	<b>956.4</b>	<b>944.2</b>	<b>954.2</b>
<i>Memorandum item: Year-on-year inflation</i>	10.10%	10.10%	11.60%
<i>Memorandum item: Real GDP growth</i>	2%	2%	1%

Source: Ministry of Finance and Economy, Fiscal Council

**There are considerable risks that the budgeted non-tax revenue will not be collected as planned.** Non-tax revenue is a very heterogeneous category of budget revenue that includes revenue from fees, charges and fines, sales of goods and services, revenue from property, as well as taking profit from public enterprises. The collection of this revenue category was relatively unpredictable and subject to different types of risks in the past. Thus the collected non-tax revenue will be (at least) RSD 15 billion lower this year than initially budgeted, primarily as a consequence of the government's inability to collect significant funds from bankruptcy proceedings in the planned period. This risk remains current next year as well, considering that the collection of considerable funds from bankruptcy proceedings is planned by the 2013 Budget as well. Another big uncertainty is the possibility for the withdrawal of profit from public enterprises, considering that the initially budgeted revenue on this basis will not be achieved this year. Given the economic recession during 2012, taking profit from public enterprises during 2013 in (approximately) the same amount as this year will be uncertain. Thus the Fiscal Council believes that some of the numerous risks in the non-tax revenue category will materialize during next year, which will render it impossible to collect all the budgeted funds in this revenue category.

### ***3.3. Analysis of expenditure from the Draft Budget Law for 2013***

**The expenditure of the republican budget is planned in a restrictive manner.** The planned expenditure of the republican budget in 2013 is around RSD 1,078 billion and is around RSD 45 billion higher than the expenditure from the supplementary 2012 budget. Although this change presents a 4.4% nominal increase, the republican expenditure will decrease in real terms next year due to high inflation – by more than 6% (depending on the level of inflation next year). Not only real but also nominal reduction relative to 2012 is planned for certain expenditure, such

as the procurement of goods and services, subsidies and budget loans, i.e. their real decrease of more than 10%. Therefore, our assessment is that the expenditure in 2013 is planned in a restrictive manner.

**Changing the course of fiscal policy – from expansionist to restrictive – will be a major challenge, because of which the Government prepared some additional measures as well.**

The experience of previous years has shown us that it was possible to breach severely the expenditure restrictions in some budget beneficiaries during the year. Namely, during the year the expenditure was executed much faster than planned and then this increase was built in the supplementary budget, which would increase the deficit as well. The Draft Budget Law, however, made a noticeable step forward in terms of controlling the execution of the planned expenditure, because the 2013 Budget provides for a system of early announcement of liabilities and expenses and priority selection – because of which we expect that there will be an improvement in planning during the budget year.

**The Fiscal Council estimates that, with current policies, the expenditure of the Republic will most probably still be around RSD 20 to 25 billion higher than the planned.** The Fiscal Council analyzed the budget plan for next year by individual public expenditure item and assessed how realistic it is. Our analysis indicates that the expenditure for subsidies, the procurement of goods and services, other current expenditure and social security in 2013 will most likely exceed the plan by RSD 20-25 billion in total. The reasons for the variance from the plan are: 1) too optimistic planning – which accounts for a variance of RSD 15 to 20 billion and 2) acceleration of inflation (a variance of around RSD 5 billion).

**There are also some risks that the expenditure will exceed the plan even more in next year.** The Fiscal Council's analysis indicates several risks that may lead to further increase in expenditure next year (beyond the already identified RSD 20-25 billion). Thus, the budget for next year does not plan any funds for the Smederevo Steel Mill, because the Government expects that this company will be privatized soon, without any expenses from the budget. Still, the Fiscal Council believes that there are risks that this process will not go as planned, which would probably increase the budget expenditure. The Draft Budget provides for the payment of the two outstanding installments from the "Thirteenth Pension Program", although there already are some public announcements that this program will evolve from being a one-off aid to a permanent right, which would also increase the budget expenditure in next year – by around RSD 4 billion. The last and probably the most dangerous risk is that there will be problems in the implementation of the announced 2% indexation in April, because inflation could be much higher than that expected until only a month ago when the agreement on the indexation was made.

**Any further increase in the deficit is also possible because of the payment of arrears accumulated in the health care system and for the maintenance of road infrastructure.** Some segments of the public sector were late in paying their liabilities in the previous years and thus accumulated the arrears that they will not be able to pay by themselves without the help of the republican budget. The precise mechanism by which the government will solve this problem is not yet fully known, but it is possible that there will be an increase in expenditure of the republican budget on this basis. The Fiscal Council believes that solving the issue of arrears in 2013 is justified provided that reforms of critical segments of the public sector are previously

introduced that will prevent new creation of arrears after the “bailout” by the Republic.<sup>14</sup> In addition, it should be well considered where and to what extent the intervention from the republican budget is necessary and which segments of the public sector that have accumulated arrears are able to cope with them by themselves. Thus, for example, the Fiscal Council does not consider it to be justified to help local self-government units from the republican budget on this basis, since the local self-government units already got an increase in their revenue by around 20% in 2011 at the expense of the republican budget by amendments to the Law on Local Self-Government Financing.

### ***3.4. Analysis of individual expenditure items of the republican budget***

**The restriction of increase in expenditure for employees (along with pensions) will ensure key savings in 2013.** Allocations for wages will decrease by more than 4% in real terms in 2013. This will be a consequence of relatively low indexation of wages in October 2012 and April 2013 by 2% each. Since this indexation (2%+2%) is lower than the inflation that will be recorded in the observed period, the public sector wages will decrease considerably in real terms and thus bring necessary savings to the republican budget. If there had been no restriction of indexation, we estimate that the expenditure for wages would have been around RSD 20 billion higher than it is now, which would then probably mean an increase in the deficit by the same amount. Therefore, once again we emphasize the significance of consistent application of indexation of wages (and pensions) in the public sector as probably the key measure of fiscal consolidation on the expenditure side of the budget.

**The trend in the employee expenditure in next year is realistically planned by the budget – however, it is a cause for concern that a higher increase in wages than the statutory indexation has been planned and implemented for years.** The draft budget for next year planned a nominal increase in allocations for employees of around 7% relative to 2012. The planned indexation (with no increase in the number of employees) indicates that the increase in allocations for employees would have to be somewhat lower and be around 4.5%. The practice of faster increase in wage allocations was observed already a few years ago – because, even when the wages were formally frozen (in 2010), there was an increase in allocations for wages from the republican budget by more than 2%. Therefore, we believe that planning higher allocations for wages than indicated by the indexation is realistic but that this further increase deserves a detailed explanation in the budget. It was observed that the plan was to increase the number of employees in certain public administration sectors in 2013<sup>15</sup>, which, however, can only partially rather than completely explain the higher increase in allocations for employees in 2013. Finally, the Fiscal Council welcomes the planned tightening of the procedure for admission of new employees in the public sector (Draft Budget Law, Articles 38-41).

**Within the employee expenditure, wage benefits are again planned for certain ministries in 2013 – in our opinion, quite without justification.** Thus, as much as RSD 7 billion is planned for the Ministry of the Interior in 2012 as well for social benefits for

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<sup>14</sup> Solving this problem will certainly cause an increase in the public debt, so it is probably a more transparent and better way to see the costs of this measure through the expenditure of the republican budget and even through the deficit increase.

<sup>15</sup> Employment of 500 fire-fighters and 97 employees in the Security Intelligence Agency

employees. We pointed out the increase in these allocations and that they were unjustified already during the 2012 budget revision.<sup>16</sup> Now we notice that this measure, introduced in 2012, is planned for 2013 as well, so we suggest its abolishment (or at least a reasonable reduction of such a large and, apparently, completely wrongly allocated appropriation in the budget).

**Restriction of expenditure for pensions is, besides wages, the foundation on which the fiscal consolidation on the expenditure side of the budget rests.** The expenditure for pensions (at the consolidated government level) will increase by 5.6% in nominal terms in 2013, which is a consequence of the planned low indexation and the expected increase in the number of pensioners. Taking into account inflation as well, we expect that the allocations for pensions will decrease by more than 5% in real terms in 2013 relative to 2012. The restriction of indexation of pensions in October 2012 and April 2013 will cause a decrease in deficit by more than RSD 25 billion in 2013.

**The restriction of increase in pensions will cause a decrease in the republican deficit.** There is a large imbalance between the revenue and expenditure of the Pension and Disability Insurance Fund, which is covered from the republican budget. Therefore, a regular payment of pensions in Serbia is only possible because the republican budget transfers to the Pension and Disability Insurance Fund around half the funds needed for the payment of pensions. The restriction of increase in the allocations for pensions will lead to a certain decrease in this imbalance in addition to the necessary savings. Namely, since the revenue of the Pension and Disability Insurance Fund on the basis of contributions will increase by around 9% and the expenditure for pensions will increase by around 5.6%, this will partly reduce the need for transfers to the Pension and Disability Insurance Fund from the republican budget and thus decrease the republican deficit (despite all of the above, the transfers to the Pension and Disability Insurance Fund will still have to increase in nominal terms in 2013, but only by 2.8%).

**Savings in allocations for pensions and public sector wages are justified, because Serbia allocates (in relative terms) much more for these purposes compared to other European countries.** With the share of pension allocations in GDP of 14.4% of GDP and 11.4% of GDP for wages,<sup>17</sup> Serbia ranks first in Europe. Therefore, we consider the savings in these expenditure items to be justified. The Fiscal Council also believes that the short-term savings were only possible by restricting indexation (the same standard for all) but that, in the medium term, the necessary further savings should be achieved by reforms aimed at correcting inequities in the existing systems (early retirement, redundancies, different wages for the same jobs and alike).

**The expenditure for the procurement of goods and services, together with other current expenditure, is planned in a very restrictive manner.**<sup>18</sup> A nominal reduction of this expenditure by 7.7% and a real reduction by as much as 17% are planned. The expenditure for goods and services and other current expenditure should be reduced by around RSD 21 billion in

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<sup>16</sup> This amount is equivalent to a RSD 120,000 annual wage benefit to each employee in the Ministry of the Interior. Apart from the amount, its purpose – social benefits for employees in the public sector segment in which wages are already significantly higher than the average in the country – is questionable as well.

<sup>17</sup> These percentages will decrease slightly with the expected change in the methodology for calculating GDP (inclusion of grey economy). However, this will not change our assessment that the allocations for pensions and public sector wages in Serbia are proportionally higher than in other countries. It should also be noted that the common methodology for calculating public sector wages, in contrast to Serbia, includes wages in full gross amount.

<sup>18</sup> Because of a relatively low value of allocations for other current expenditure, in our analysis we merge it with the expenditure for procurement of goods and services. The IMF also uses such methodology.

order to achieve this target. Namely, if the 2012 expenditure were kept unchanged in real terms in 2013, this would mean that it would be precisely that much higher than that planned for 2013. A question arises as to whether the planned reduction of expenditure is objectively achievable – especially because it does not involve almost any concrete programs and reforms but is based on the imposed restriction of allocations to budget beneficiaries and the assumption that there are inefficiencies in the execution of this public expenditure item. An additional risk of breaching the planned envelope of expenditure for the procurement of goods and services is, with increasing likelihood, a further increase in inflation – because the plan of expenditure for goods and services was prepared with an assumption that the average inflation in 2013 will be 10%.

**First, it should be kept in mind that a part of the necessary savings in 2013 will result from excluding the one-off expenditure incurred in 2012, so it will be possible to reduce this expenditure even without any special measures.** Thus, there will be no one-off costs in 2013 that relate to the elections held in 2012. By this we mean the direct costs of holding the elections, but also the already practically standard pre-election expansion, which, to a significant extent, results in a temporary increase in the expenditure for the purchase of goods and services immediately before the elections.<sup>19</sup>

**Another necessary part of savings could result from reducing the expenditure previously funded from own revenues.** Material costs of most budget beneficiaries remained unchanged in nominal terms in the budget or are even lower in nominal terms than in 2012.<sup>20</sup> This is a reflection of the intended savings and the desire to reduce the public expenditure, which is desirable and necessary. However, the achievement of the plan is not certain, since there are not enough systemic measures that would provide for the streamlining of operation of budget beneficiaries. Amendments to the Budget System Law created the preconditions for reallocating the previous own revenue of budget beneficiaries to the budget, which created the necessary condition for the streamlining of expenditure that the budget beneficiaries funded from their own revenue. However, the condition was not sufficiently met because no clear plan was determined by which the total level of public expenditure would be reduced. Adjustment may only be discerned in the case of the terminated Environmental Protection Fund, which had RSD 4.3 billion budgeted in the specialized services item in 2012, and, after the termination of this institution, these funds were not planned in the chapters of related ministries or other agencies in the 2013 budget. It indirectly follows from this that savings are planned on the basis of terminating the Environmental Protection Fund and reducing the earlier expenditure of this institution. However, a question arises as to whether this will be achievable, bearing in mind that the Environmental Protection Fund funded support to the construction industry and energy efficiency and environmental protection projects and that it was not announced that these forms of government intervention would be abandoned. If the projects continue, then this will show that the termination of the Environmental Protection Fund fails to achieve sufficient savings. Thus, the above example shows that a clear position and a credible plan are needed in connection with the projects and programs that are abandoned after the abolishment of own revenues and the desirable and budgeted public expenditure streamlining. Otherwise, there are considerable risks that the expenditure will be higher than the planned.

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<sup>19</sup> Including other current expenditure as well.

<sup>20</sup> They are lower or at the same level in nominal terms in 2013 compared to 2012 in, for example, the Ministry of Defence, the Ministry of the Interior and the Ministry of Foreign Affairs. A particular problem is that there is also a difference in the structure and composition of ministries between the previous Government and in the new Government (and in the budget), which prevents any accurate analysis.

**The government improved the system of planning and determining priorities in the expenditure execution, which will undoubtedly have a positive fiscal effect.** Article 12 of the Draft 2013 Budget Law specifies that the expenditure for recurrent costs, costs of current repair and maintenance and supplies, as well as capital expenditure have priority in the execution of the expenditure for goods and services of budget beneficiaries and local self-government units. If the budget beneficiaries act otherwise, the allocations to the budget beneficiaries and transfer payments will be reduced. This should also include the effects of the latest amendments to the Budget System Law, which stipulates that budget beneficiaries must inform in a timely manner the Treasury of their intention to assume a commitment and effect the payment, which creates the conditions for more successful liquidity planning of the Treasury and more responsible behavior of budget beneficiaries.

**This lowers the risk of a supplementary budget in the second half of 2013 that would significantly increase the deficit.** Until now, the expenditure for the procurement of goods and services could be executed during the year by executing and even exceeding the planned expenditure, particularly that of a discretionary nature, for the entire year well ahead of time. At the same time, other liabilities of the ministries, which actually cannot be avoided – payment for utilities and other recurrent and unavoidable costs – were delayed. The consequence of such behavior was that there had to be an increase in expenditure and thus a breach of the deficit envelope by the supplementary budget. The introduction of the measures for better expenditure planning will reduce the possibility for creation of arrears, and the effect will also be a reduction of unnecessary expenditure of budget beneficiaries that, until now, could be funded while accumulating arrears for basic costs.

**We estimate that savings of RSD 10-15 billion of the planned RSD 20 billion may be achieved on the basis of the above effects (elimination of one-off costs, transfer of own revenue to the budget and establishment of priorities and the system of announcement of commitments and costs).** Although our assessment of all of the above changes is positive, they cannot fully compensate for the lack of a clear plan for the reduction of public expenditure. Therefore, there are considerable risks that the funds provided for by the budget will not be sufficient for the procurement of goods and services. We estimate that at least RSD 5 billion and probably as much as RSD 10 billion will be missing in the “expenditure for the procurement of goods and services” item by the end of the year.

**Allocations for interest posted the highest increase in 2013 relative to all other expenditure, as a consequence of a high fiscal deficit in the previous years and an unsustainable trend of increase in public debt.** The interest expenditure will increase in 2013 relative to the previous year by around RSD 24 billion or around 37% (in nominal terms). Already now, the allocations for interest are becoming one of the largest items of the republican budget (around 8.5% of the total budget) and in 2013 they will exceed the allocations for the procurement of goods and services (without other current expenditure) and the allocation for subsidies. When studying the purpose for which the money from the republican budget is spent, it can be observed that the interest expenditure exceeded the allocations for defense, agriculture and half the government allocations for education and science. Thus, any further increase in interest allocations is unsustainable and the fiscal deficit, as the main driver of public debt and increase in interest allocations, must be sharply reduced. At another level, we believe that it would also be necessary to improve the structure of debt in terms of interest level and debt maturity in order to prevent further, almost uncontrolled, increase in interest allocations.

**There are serious risks to see interest rate expenditure somewhat higher than the planned one – by at least RSD 5 billion.** Fiscal Council analysis shows that the funds planned to cover interest rates in 2013 are 5 billion lower than the required one.<sup>21</sup> In addition, there is also a big risk for interest rate expenditure to be even higher. First of all, if one has a look at the structure, almost half of the interest rate expenditure is indexed in foreign currencies. Therefore, in case of foreign currency strengthening (RSD depreciation), these expenditures would be increased as well. Also, in case planned deficit level is exceeded, and this option is not ruled out in our analysis, it is quite possible to see extra funds for financing deficit to be provided through a short-term credit, which may then lead to slight increase in interest rate expenditure, even in 2013.

**Subsidies are planned at a level that is RSD 7 billion lower than in 2012, but this is completely a consequence of lower allocations for FIAT and a change in the structure of allocations for road maintenance rather than serious savings in this expenditure item.** The value of the planned subsidies in 2013 (RSD 82.2 billion) is lower than the subsidies in the 2012 Supplementary Budget (RSD 89.2 billion), with this reduction resulting from the decrease in subsidies (lower liabilities) for the FIAT project from RSD 13.6 billion to RSD 5.7 billion and the decrease in subsidies for the Roads of Serbia Public Enterprise of around RSD 2.5 billion, which were replaced and even increased by transfers to local community for road maintenance. Excluding FIAT and road subsidies, the total subsidies actually increase by around RSD 3.5 billion. The Fiscal Council does not consider it justified to allocate such a large amount of funds for subsidies, and a detailed analysis has shown that even these, generously planned, funds will most likely not be sufficient for implementing all of the planned programs in the field of subsidies.

**New programs for granting subsidies and budget support are introduced, in contravention of the imperative to cut back this type of expenditure in the process of fiscal consolidation and building of a market economy structure.** In 2013 the planned envelope for subsidies to enterprises goes up by around RSD 2 billion. In 2013 certain subsidies from 2012 have not been planned, such as subsidies for the sale of locally-produced tractors, trucks and buses or investment in the Mining and Smelting Complex Bor (RTB Bor) – and it constitutes a step in the right direction. But on the other hand, other subsidies and net lending (budget loans) have been increased in amounts that are higher than the savings made. As a consequence, the draft 2013 budget has created new programs and incentives: for shipbuilding (RSD 1.2 billion), to Republika Srpska for the purchase of carriages from Serbia (RSD 1.2 billion), or increased the existing programs: a loan to Republika Srpska for the purchase of computers from Serbia (an increase by around RSD 400 million) and subsidies for housing construction (a rise by around RSD 900 million). We believe that, in parallel with the completion of certain subsidy programs, new programs should have been abandoned, thus lowering expenditure for subsidies and total public expenditure.

**There is a prevailing risk that the allocation for subsidies to investors will exceed the planned amounts in execution.** Subsidies for investment and employment should compensate for the lack of an enabling environment for investment in Serbia. In 2013 these subsidies are planned to grow by around RSD 2.2 billion (from RSD 6 to 8.2 billion). This is the continuation

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<sup>21</sup> Preliminary projections of the Ministry of Finance and Economy show that the interest rate expenditure will also exceed the Draft 2013 Budget Law by 4 billion. Since the presumptions on the public debt level and structure have not been changed significantly in the meantime, further interest rate expenditure reduction may implicitly stand for a change in foreign currency projection by around 8% - which is considered unjustified.

of the policy from previous years, despite the fact that it is fiscally unsustainable and economically undesirable in the medium term. For the investments already negotiated by end-October 2012, the liability related to the payment of incentives in 2013 amounts to RSD 7.7 billion, which is almost exhausting the budgeted amount for this purpose for the entire coming year. In case new agreements were signed by the end of this year and in the course of next year, which would imply the payments of incentives to investors, it would mean that budget allocations will not be sufficient to meet contractual obligations of the state. Consequently, in order for the planned amounts to be sufficient for effective expenditure, it is necessary to suspend the assumption of new commitments for subsidizing investors by end 2013, which does not seem very likely in light of the announcements by economic policy-makers. Therefore, the risk prevails that the necessary resources for subsidies in the coming year will exceed the planned amounts.

**Table 3. Subsidies in the 2012 Supplementary Budget and the 2013 Draft Budget, excluding FIAT (RSD billion)**

	2012	2013	Difference (2013-2012)
Subsidies for the economy	23.1	17.3	-5.8
for FIAT	13.6	5.7	-7.9
other subsidies	9.5	11.6	2.1
Subsidies for agriculture	32.5	32.8	0.3
Subsidies for railways	13.8	14.6	0.8
Subsidies for roads	8.8	6.3	-2.5
Subsidies for tourism	2.6	2.7	0.1
Subsidies for culture	0.4	0.4	0
Other subsidies	8.1	8.2	0.1
Total	89.2	82.2	0.9

Source: Ministry of Finance and Economy, Fiscal Council

**Resources needed for subsidizing liquidity loans will be higher than budgeted.** In 2012 RSD 1.3 billion will be paid for subsidized interest rates on the basis of approved liquidity loans in the last four months of 2012. The maturity of underlying loans is eighteen months, hence the loans approved in 2012 and potential new loans approved in 2013 will be repaid throughout 2013. The necessary amount for subsidized interest rates in 2013 will be more than three times higher than in 2012<sup>22</sup>; consequently, the budget allocation for this purpose (RSD 2.7 billion) is by at least RSD 2.5 billion lower than what is needed.

**Subsidies to the railroad company remain the highest single expenditure for subsidies granted to an individual company, and we believe that they should be cut back and/or that the purpose for which they are provided should be changed.** Subsidies for the railroad company amount to RSD 14.6 billion and have gone up by around RSD 800 million in 2013, because the subsidies are used to pay (indexed) wages in the railroad company. We would like to recall that the problem here is the structure, not the amount – granted subsidies should be used

<sup>22</sup> On the (restrictive) assumption that no liquidity loans will be approved in 2013.

for investment in infrastructure priorities, not for wages of workers in the railroad company, whose number is probably too high.

**The consequences of modified incentives in agriculture for public expenditure are not clear, because the new draft law does not contain the mandatory estimates of financial effects.** The draft law on incentives in agriculture and rural development (of 25 October 2012) regulates incentives in agriculture in a systemic manner, and in that respect it constitutes a positive change relative to the agricultural policy measures so far. That is to say, instead of defining incentives by annual decrees, as has been the practice so far, farmers will get a more stable, more predictable and more transparent framework which will enable them to make long-term plans.<sup>23</sup> The rationale for the draft law, however, does not contain estimates of financial effects on the budget for the current and coming two years, which is a statutory obligation (under Article 48 of the Budget System Law). The amount of subsidies for agriculture budgeted in 2013 is equal to the allocations in 2012 and there is a risk that this envelope will not be sufficient for the payment of all liabilities under the new law. The draft law prescribes minimum incentives and contains a provision under which maximum incentives are set depending on the available resources in the budget. Still, bearing in mind that the criteria for support to agriculture have frequently changed<sup>24</sup>, it is possible that there are no statistical records and a comprehensive evaluation of effects, which would be necessary for an objective estimate of resources needed for incentives under to new law. In that respect, there is a considerable risk that planned resources will not be sufficient for all the payments arising from new commitments of the government, and a need may arise in the course of the year for a supplementary budget, and for increasing the allocations for support to agricultural production.

**Outflows for acquisition of financial assets have been reduced in nominal amounts, because part of the funds for the Smederevo Steel Mill – which has not been included in the plan for 2013, was paid from this item.** Outflows for acquisition of financial assets are considered together with direct subsidies, because they are essentially very close. In 2013 these outflows will be reduced by around RSD 4.1 billion (from RSD 14.5 to 10.4 billion) which basically corresponds to the expenditure from the Republican budget for the Smederevo Steel Mill. Although the intention of the Government to privatize this company, and thus stop granting subsidies to it, is clear, we believe that the non-budgeting of this expenditure can be characterized as optimistic planning of budget expenditure.

**In our opinion, allocations for subsidies will exceed the planned amount by RSD 5 to 10 billion.** Bearing in mind a strong possibility that subsidies for agriculture, subsidized interest rates on liquidity loans and subsidies to investors could be higher than budgeted, our assessment is that there is a risk of execution of subsidies exceeding the budgeted amount by RSD 5 to 10 billion. If it turns out that additional allocations should be made for the Smederevo Steel Mill in the coming year, this gap could easily exceed RSD 10 billion.

**Expenditure for social benefits may be higher than the plan due to higher inflation.** Certain social benefits are indexed two times a year to inflation growth. In the process of next

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<sup>23</sup> More uncertainty surrounds incentives for plant production (Article 16), because depending on the available budget resources, the Minister may limit the area for which incentives are paid, and the type of plant production and the crops for which incentives may be provided, as well as the terms thereof, are also prescribed. Although such provisions of the law deviate from the predictability principle, they are more fiscally responsible because the measures in agriculture are aligned with a broader budgetary framework.

<sup>24</sup> Criteria for acquiring the right to incentives have been changing, as well as the types of incentives, fields of incentives and amounts of incentives.

year's budget preparation, an adjustment of RSD 1 billion was already made due to higher inflation which had been registered in the data up until September. It is the assessment of the Fiscal Council that a gap for other social benefits will probably amount to another billion or two dinars, considering that we do not expect the acceleration of inflation growth to end in September, and that it will affect one more planned indexation of social benefits.

**There are announcements of the extension of the one-off “Thirteenth Pension Program” for aid to pensioners, despite the fact that such extension has not been planned by the budget.** The Thirteenth Pension Program has been defined in the coalition agreement as a one-off program lasting for a year. With the payment of the last two installments of this aid in 2013 this program would be concluded and that is how the budget for the coming year has been planned. Public announcements have already been made to the effect that this program could be transformed into a permanent right, instead of being a one-off aid. If that happened, budget expenditure would exceed the planned framework by further RSD 4 billion. We would like to note that the Fiscal Council made an assessment back in its previous reports that this program was non-selective, overly generous and poorly targeted.<sup>25</sup>

**Transfers from the Republican budget to local self-governments have been increased.** The allocation for regular, general transfers to local self-governments, which amounts to RSD 35 billion in the 2013 budget, has been topped up by an amount of RSD 3 billion (and 0.9 billion for the *Roads of Serbia* for winter maintenance of local roads). We believe that the increase in the allocation for transfers to local self-governments is definitely not justified, because the additional RSD 40 billion from 2011 (which accrued to local self-governments at the expense of the Republic through the amendments to the Law on Local Self-Government Financing), is such a generous amount that all municipalities should have been able to absorb the costs of maintenance of local roads.

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<sup>25</sup> For more details see the opinion of the Fiscal Council of the 2012 supplementary budget.

**Table 4. Planned Expenditure of the Republican budget in 2013**

In billions of RSD	Supplementary budget	Budget for 2013	Estimate of the Fiscal Council
<b>TOTAL EXPENDITURE AND OUTFLOWS</b>	1,033.2	1,078.3	1,095.3
Current expenditure	975.8	1,021.0	1,038.0
Employee expenditure	249.3	266.2	266.2
Expenditure for use of goods and services	92.5	87.9	93.9
Expenditure for interest payments	65.9	90.1	90.1
Subsidies	89.2	82.2	89.7
Transfers to other levels of government	73.4	75.5	75.5
Other transfers	1.5	2.9	2.9
Transfers to mandatory social insurance funds	291.2	302.9	302.9
Social protection from the budget	94.0	100.9	102.4
Other current expenditure	16.3	12.5	14.5
Capital expenditure	42.8	46.9	46.9
Outflows for acquisition of financial assets (for the purpose of public policies implementation)	14.5	10.4	10.4

Source: Ministry of Finance and Economy, Fiscal Council

**It was planned for capital expenditure in the 2013 Republican budget to be approximately at the 2012 level in real terms.** That is to say that the next year's budget provides for a nominal increase in allocations for capital expenditure in 2013 of around 9.6%. The Fiscal Council is of the opinion that this growth is insufficient. Namely, even if the public investment plan in the Republican budget<sup>26</sup> was materialized, that would imply an actual decline in the share of such investment in GDP, because nominal GDP growth will be a bit higher. The Fiscal Council considers a drop in the investment expenditure-to-GDP ratio to be an undesirable economic policy. An additional problem is related to the fact that the practice has shown that public investment is the only segment of public expenditure which is, as a rule, substantially cut back in supplementary budgets, because the easiest and the least painful savings are made in this budget line. Therefore, it is possible that even such, relatively modestly planned, public investment out of the Republican budget will not be executed by the end of the year.

### ***3.5. Guarantees in the Draft 2013 Budget Law***

**Progress has been made in the field of government guarantee issuance.** The 2013 budget provides for the issuance of guarantees worth around RSD 41 billion for a total of six projects,

<sup>26</sup> Probably contrary to the impression created in the public, only one third of government public investment is funded out of the Republican budget. The largest spending on public investments is at the level of local self-governments.

with all the projects involving capital investments.<sup>27</sup> By way of comparison, the 2012 budget provided for guarantees worth around RSD 273 billion for 29 projects, while several guarantees were even earmarked for liquidity loans to public enterprises.<sup>28</sup> The positive thing is that no issuance of guarantees has been envisaged for liquidity loans, and that the amount of planned guarantees is considerably lower than in the previous year. In its analyses and reports, the Fiscal Council pointed to the need to plan guarantees, earmark them for certain priorities and reduce their amount. We would like to recall that one of the reasons for the suspension of the previous IMF arrangement was the excessively high envelope for guarantees in 2012.

**The planned guarantees were provided for in 2012 as well.** All the guarantees in the draft 2013 budget (with the exception of the pipeline Aleksandrovac-Kopaonik-Novi Pazar-Tutin) were planned in the 2012 budget, too, and it often happens that the plan for issuance of guarantees for the same projects is repeated over a period of several years, since loans have not been disbursed. This fact corroborates the assertion that projects are poorly planned, which is then reflected on the budget plan. It can be noticed that the issuance of a guarantee to commercial banks for borrowing by the JP “Emisiona tehnika i veze” (for the project “The process of transition from analogue to digital and crystal clear picture”) is planned in 2013 as well, and the same guarantee in the same amount was planned in the previous year in favor of the European Bank for Reconstruction and Development. It turns out that financing sources for the project have been substituted – instead of a loan from an international organization on more favorable terms, the plan is now to finance the project with a loan from commercial banks, which is the cost of delays in the implementation of the planned project.

**The credibility of the guarantee plan and the commitment to introducing order into this field in 2013 have been seriously undermined by the room which was left for approving additional guarantees.** The step which turns the field of guarantees away from a healthy and sustainable system was made in the third part of the Draft Budget Law. It relativizes the established framework for guarantees in 2013. Namely, Articles 34-36 of the Draft Budget Law (in the third part – Budget Execution) stipulate that the Government may borrow and approve additional guarantees in the amount of EUR 400 million (which would practically constitute the doubling of the original envelope for guarantees as set out in Article 3 of the Draft Law). Moreover, additional guarantees may be approved in an exceptionally large number of cases and in a rather non-selective manner: for the purpose of ensuring financial stability, implementing the privatization process, debt sustainability, financing or refinancing of debts of direct and indirect budget beneficiaries, giving guarantees to a legal entity founded by the Republic of Serbia which performs lending activities, insurance activities or activities related to issuance of guarantees. Hence, an option has been left for the government to approve loans and issue guarantees for borrowing by budget beneficiaries for different needs, and through state institutions, also for support to the private sector (as a measure for supporting production and investment activities of business companies). In the group of the above cases, instead of non-selective support to budget beneficiaries and all business companies, it is only justified to provide for additional borrowing and guarantees for interventions in the financial sector, on account of the systemic risk. A similar additional envelope also existed in the previous budget, but it was lower (EUR 300 million), and

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<sup>27</sup> Two loans for the *Serbian Railroads a.d.*, two for PE *Srbijagas*, one for PE *Serbian Power Industry* and one for PE *Broadcasting Technology and Links*.

<sup>28</sup> In practice, guarantees were lower than planned, since envelopes for approval of guarantees in the budget were traditionally too high and plan did not materialize during the year. Thus, the supplementary budget for 2012 almost halved the plan for guarantees compared to the original plan (it was reduced to around RSD 149 billion).

the list for interventions and additional guarantees was shorter. Accordingly, the earlier bad practice has been further exacerbated by the new budget.

#### 4. AN ANALYSIS OF THE FISCAL POSITION OF LOCAL SELF-GOVERNMENTS

**From among all levels of the general government, local self-governments posted the highest expenditure increase in 2012.** During the first eight months of this year, relative to the same period last year, expenditure of local governments went up by as much as 16.4% in real terms. The massive surge in public spending at the local level is mainly the consequence of increases in revenue by RSD 40 billion, due to the amendments to the Law on Local Self-Government Financing of 2011.

**Not only is the increase in the level of public spending at the local level problematic, but also the deterioration of its composition.** In the course of the first eight months of this year, capital investment at the local level went up by 8.6% in real terms, employee expenditure increased by 11.4% in real terms, social benefits by 18.2%, goods and services by 23.4%, while subsidies at the local level surged by 28.9% in real terms. Although there were expectations that local self-governments would mostly use additional funds to increase capital expenditure, initial data shows that the increase in this type of expenditure is actually the smallest, while discretionary expenditure for goods and services and subsidies recorded the highest growth rates. On the other hand, despite the substantial increase in available funds, local self-governments have not yet cleared accumulated arrears from the previous period, which have reached the level of RSD 13 billion. Similarly, the number of examples of reckless spending at the local level is rapidly growing, such as employment of new staff or setting up of new agencies, companies and the like. A similar deterioration of the economic structure of public spending was also recorded during the relaxation of the fiscal position of local governments in the period 2004-2006.<sup>29</sup> For that reason, the establishment of vertical fiscal balance between the Republican and local levels of government – arises as a priority in the forthcoming period.

**Vertical fiscal imbalance (the ratio between resources and matching liabilities) between the Republican and local levels of government amounts to around RSD 20 billion in favor of local self-governments.** This imbalance, which was created primarily by changes in the Law on Local Self-Government Financing in 2011, needs to be eliminated as soon as possible in order to put a stop to the propagation of unproductive forms of public spending at the local level, and the consequential deterioration of the efficiency of the entire government sector. As the best solution for the re-establishment of vertical balance, the Fiscal Council proposes systemically made cuts in the total amount that local self-governments receive from the wage tax and (general) transfers from the Republican level, by about RSD 20 billion in order to narrow the deficit at the level of the Republic.<sup>30</sup> Vertical balance (hypothetically speaking) could also be re-established by delegating additional competences to local self-governments in the rough amount of RSD 20 billion. Nevertheless, the experience from international practice, as well as a recent unsuccessful attempt to delegate competences for the maintenance of 6,000 kilometers of regional roads, suggests that (forced) delegation of additional competences to local self-governments will not bring about desired fiscal effects in the short run. Enabling local self-

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<sup>29</sup> For more details see Sestovic, L, 2008, „Macroeconomic and Fiscal Aspects of Decentralization“.

<sup>30</sup> The mentioned cuts can be achieved either by reducing the share of the wage tax that accrues to local self-governments or through cuts in the amounts of transfers. For more details see the Chapter „Establishing a Sustainable System of Fiscal Decentralization“ in the text „Opinion on Fiscal Strategy for 2013 with Projections for 2014 and 2015“.

governments to assume additional competences and obligations, over the medium term and in a well-designed and systemic manner, is not disputable but the existing fiscal imbalance between Republican and local levels of government needs to be redressed in the short run in the same manner in which this imbalance was created in the first place – through an effective transfer of funds in the amount of RSD 20 billion from the local to the Republican level of government.

**As the first measure for mitigating vertical imbalance, the Fiscal Council proposes to finance the RSD 4 billion for the maintenance of 6,000 kilometers of re-categorized regional roads in 2013 – out of local budgets instead of the Republic’s budget.** The re-categorization of 6,000 kilometers of regional roads into local roads in March this year has formally created a new liability of local self-governments in the total amount of around RSD 4 billion. The re-categorization was not done in a systematic manner, so the new liabilities of particular municipalities did not correspond to additional revenue that accrued to municipalities under the 2011 law amendments, which has further aggravated horizontal imbalance among different municipalities. However, relative to the initial systemic Law on Local Self-Government Financing of 2007, amendments to the Law in 2011 have additionally increased the available funds at the local level by more than RSD 20 billion in total. Therefore, the local level of government was definitely able to assume the RSD 4 billion of additional liabilities for the maintenance of re-categorized roads. Moreover, detailed projections of the Fiscal Council for individual municipalities and cities confirm that even underdeveloped municipalities were able to absorb additional costs for road maintenance.<sup>31</sup> If there are operational challenges for local self-governments to take over the maintenance of more roads, it is possible to restore the competences of the Republican level regarding the maintenance of these roads – but the *key thing is the coverage of the financial costs by local self-governments, not by the Republican budget*, bearing in mind very high surpluses of funds relative to liabilities at the local level.

**As the second measure for the mitigation of vertical imbalance, the Fiscal Council proposes a temporary suspension of transfers from the Republican budget to more developed cities in the 2013 budget.** Cities with development levels above the average had the largest increase in the funds after the 2011 law amendments, in absolute amounts.<sup>32</sup> Therefore, by suspending transfers to cities with development levels above the average, savings could be made in the Republican budget of more than RSD 7 billion. Projections show that, even after the suspension of the transfers, the most developed cities such as Novi Sad, Nis or Kragujevac, would have at their disposal more funds than under the initial 2007 Law on Local Self-Government Financing. On the other hand, several cities (Cacak, Krusevac, Pirot, Jagodina, Sabac and Sombor) would experience a partial decline in the amount of funds relative to the 2007 Law. However, even in the case of these cities, losses would be relatively modest - 2 to 3% of local budgets, which could be compensated through higher collection of property taxes.

**As a durable solution for the establishment of vertical balance, the Fiscal Council proposes the adoption of system-related amendments to the Law on Local Self-Government Financing not later than by end-2013.** The initial 2007 Law on Local Self-Government Financing, created as a joint effort of relevant representatives of towns and municipalities,

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<sup>31</sup> For more details, see the Chapter " Establishing a Sustainable System of Fiscal Decentralization " in the text "Opinion on 2013 Draft Fiscal Strategy with projections for 2014 and 2015".

<sup>32</sup> The exception is the city of Belgrade, which stopped receiving transfers from the Republic pursuant to the 2011 amendments of the law, while the share of the wage tax that accrues to it is by 10% lower than the relevant shares of other municipalities. Still, the financial position of Belgrade has remained almost identical, as if the initial 2007 law had remained in force. This fact constitutes an additional argument in favor of contemplating the idea to suspend general transfers from the Republican budget to other cities whose level of development is higher than the average.

republican agencies and the academic community, received an exceptionally positive evaluation of the professional circles, and enjoyed unequivocal support by different levels of government. Multiple non-systemic changes in the amount of funds and scope of liabilities at the local level in the course of the previous years have eroded the predictability of local self-government financing and created a large shortfall of funds amounting to around RSD 20 billion at the Republican level. Therefore the priority for the coming period is to re-establish a sustainable and predictable framework for local self-government funding, in cooperation with all relevant factors, which will systematically resolve the existing problems of horizontal imbalance among different local self-governments, i.e. a large shortfall of funds at the Republican level. The proposed (temporary) reduction in transfers to local self-governments in 2013, in the total amount of around RSD 10 billion, would help pre-empt additional (counterproductive) increases in public spending at the local level, before the adoption and entry into force of a sustainable systemic solution. The adoption of a systemic solution as soon as possible is necessary not only to eliminate the existing fiscal imbalances but to also prevent the emergence of new imbalances in 2014, when the abolition is planned of fees for the use of construction land, which account for about 0.4% of GDP of the local self-governments' revenue.

## 5. FINANCIAL PLANS OF THE MANDATORY SOCIAL INSURANCE FUNDS

**Accumulated debt and potential new debt in the coming period are the main problem in the functioning of the funds, which are integral parts of the consolidated budget of the Republic of Serbia.** It is necessary for line Ministries to make plans for resolving these problems as soon as possible, primarily the existing arrears, as well as potential new arrears, predominantly in the health care system. Namely, at the level of the consolidated general government, the funds do not contribute to the deficit because they are balanced by transfers from the central budget. The Republican Health Insurance Fund (RHIF), the Republican Pension and Disability Fund (PDF) and the National Agency for Employment (NAE) are the funds which are included in the consolidated general government. The Draft Law on the Budget of the Republic of Serbia for 2013 provides for a transfer amounting to RSD 252.82 billion to the Pension Fund and RSD 13.7 billion to NAE, while no transfers are planned for RHIF. It means that no deficit is projected in RHIF in 2013. However, experience from previous years shows that, due to a range of causes (frequent extensions of the positive drug list, non-alignment of drug prices calculations between pharmacies and RHIF, a high degree of decentralization in the procurement of drugs and hospital expendable supplies and material and the like), RHIF generates sizeable arrears which are eventually cleared from the central budget.

**The Fiscal Council welcomes the announcements of the Ministry of Finance and Economy regarding the resolution of accumulated arrears in the system for health care financing.** The estimate is that arrears in the health care system will amount to around RSD 32.5 billion by end-2012. Out of that amount, RHIF's debt stands at around RSD 17.5 billion, while accumulated debts of hospitals and community health centers have reached the figure of around RSD 15 billion. The Ministry of Finance and Economy has announced that the government will assume these arrears as public debt, at a discount, and that it will service it in the coming three years on a quarterly basis. We assess such solution as necessary for resolving the problem of accumulated arrears. In this manner, liquidity in the health care system would be restored and further failures of companies in this sector prevented. Namely, due to high debts of RHIF and community health centers to the largest distributor of drugs in Serbia, Velefarm, this company was declared bankrupt several months ago, which has caused serious turbulence on the drugs market and massive losses for this industry. However, the resolution of this problem will result in a surge of Serbia's public debt, and it is possible that part of the assumed liabilities (predominantly the liabilities of RHIF) will widen the deficit for 2013.

**In parallel with resolving the problem of accumulated debts in the health care system, it is necessary to eliminate the causes underlying their generation, in order to prevent the repetition of this problem in the future.** First and foremost, it is necessary to define priorities in financing, both for health care institutions (community health centers and hospitals) and for RHIF. The bulk of arrears generated in health care institutions over the previous period was caused by the spending for unspecified purposes by these institutions. According to the Ministry of Health, instead of paying for drugs and medical equipment, health care institutions were paying salaries of their employees, which were hired in excess of the number approved by the RHIF and the Ministry, hoping that the central government will eventually cover these debts. The estimate is that health care institutions have hired around 13,600 staff in excess of the number stipulated in contracts with RHIF, who put a heavy burden on their operation.<sup>33</sup> The

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<sup>33</sup> The estimate of the Ministry of Health

assumption of this debt by the government gives rise to a moral hazard and opens up the possibility for something like that to happen again. Namely, the state used to assume the arrears of health care institutions and other public sector institutions several times in the past, which may create expectations in the public sector that the state will be still doing that. Therefore, it is necessary to introduce order and spending controls in health care institutions and to set payment priorities. On the other hand, rationalisation of staff number and strict control over employment in health care institutions needs to be implemented since this is one of the main reasons for exceeding planned expenditure.

**Centralized purchases of drugs and medical supplies and materials can bring substantial savings owing to economies of scale, as well as contribute to curbing corruption in the health care system.** According to the records kept by RHIF, this institution spends around RSD 30 billion a year for the purchase of drugs, while another RSD 3 billion or so a year comes from individuals through co-payment for certain groups of drugs. Procurement of drugs and medical supplies is currently done in a decentralized manner, at the level of hospitals and community health centers. Procurement of drugs is made at the level of 94 health care units grouped in 30 branches (including ten units grouped in three branches in the territory of Kosovo and Metohija). Our estimate is that annual savings worth RSD 3 billion could be made by centralizing public procurement of drugs and medical supplies, on the basis of lower prices achieved through economies of scale. On the other hand, corruption pressures on doctors in health care institutions would be eased. Namely, the fact that significant amounts were spent on medical material for laboratory analysis, medical and other supplies, which some hospitals were ordering in huge quantities (larger than the average for Serbia), was raising suspicion of corruption. Savings made due to reduced corruption through centralization of public procurement of drugs and medical supplies are difficult to estimate, but they could be as high as additional 10% of the total funds spent for these purposes.<sup>34</sup> It is necessary for the line Ministries, together with RHIF, to organize a system for central procurement of drugs and medical equipment, to set up a unit in RHIF tasked with this, and to define the groups of drugs which will be procured in the coming period and the manner of their procurement, as soon as end-2012. This system has to be ready before eliminating the possibility for community health centers and hospitals to do the procurement, to avoid shortages.

**Definition of the positive drug list in conformity with EU standards is one of the assumptions for a sustainable system for financing health care in Serbia.** Part of the arrears accumulated in the previous period was caused, among other things, by frequent changes in the so-called positive drug list. It includes drugs whose purchase by beneficiaries is covered, fully or in part, by RHIF. In the period from 2004 to 2012 the number of drugs on the positive drug list was doubled (Graph 2). The last enlargements of the positive drug list, in January and September this year (additional 108 drugs on the list), will certainly push up the expenses of RHIF in 2013, although the effects of this measure are very difficult to predict.<sup>35</sup> For that reason, better controls of drug prescription by physicians, as well as the alignment of the positive drug list with the EU standards, are needed. The analysis shows that the sales of drugs in Serbia amounted to around 91.5 million in 2011, of which locally produced drugs accounted for around 66.2 million; the share of local drug producers in total annual expenditure for procurement of drugs by RHIF is about a half (around RSD 14 billion). In our view, in order to make additional savings, it is

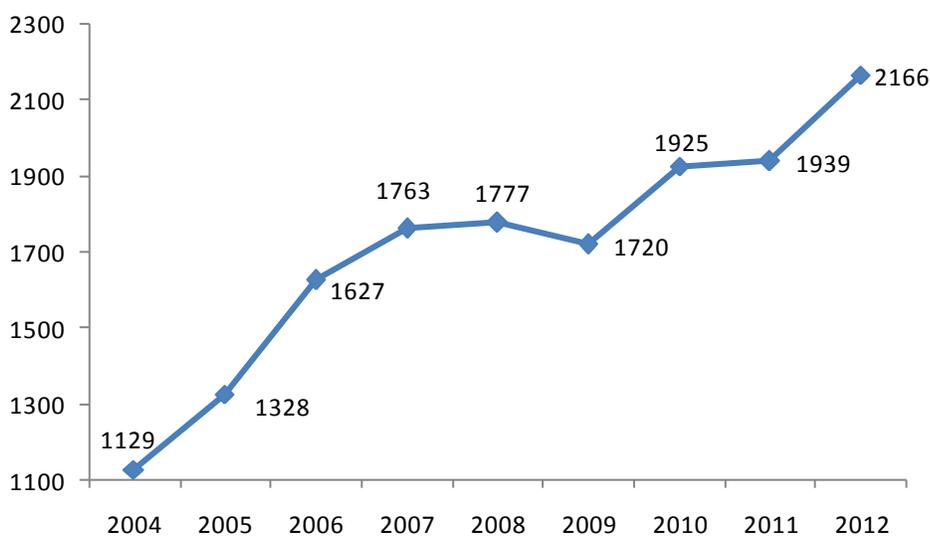
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<sup>34</sup> The estimate of the Ministry of Finance and Economy.

<sup>35</sup> According to a very rough estimate by the Fiscal Council, the costs of the enlargement of the positive drug list in 2013 will range between RSD 1 and 2 billion.

necessary to stipulate that physicians are to give priority to cheaper drugs when issuing drug prescriptions (on the assumption that substitution is possible among certain groups of drugs). Alternatively, for the same drugs produced by different manufacturers it is possible to stipulate that RHIF will only recognize the costs up to the price of the cheapest drug on the market, which complies with defined medical standards, while the differential would have to be covered either by an institution prescribing the drug or buyers. That would encourage price competitiveness on the one hand, and prevent the influence of the lobbying by pharmaceutical companies on decisions of physicians regarding the drug which they will prescribe, on the other. This would also result in an improved cost-efficiency of health care since the patients would be provided with the same quality of service, but at lower costs. We suggest to the line Ministry to analyze this option in the coming months and to come up with concrete solutions and savings that can be made in this manner.

**Graph 2. Number of drugs on the positive drug list, 2004-2012**



Source: RHIF

**The announced adjustment of the dinar - euro exchange rate which is used in the calculation of prices of imported drugs constitutes a risk for the generation of a new arrears in RHIF during 2013.** Negotiations between drug manufacturers and government and RHIF representatives over the dinar accounting rate of exchange are underway. Pursuant to the Decree on the Criteria for Setting Prices of Drugs to be used in Human Medicine that are on the Prescription Regime (*RS Official Gazette*, no. 41/11), the exchange rate which is applied to the calculation of drug prices is RSD 99.3 for one euro. Since the current exchange rate is more than RSD 114 for one euro, and the government has defined the maximum price for certain drugs, there is a risk of shortages of certain drugs on the market, due to the losses incurred by manufacturers on this basis. On the other hand, the announced raising of the accounting rate of exchange by about 15% will create additional costs for RHIF. If we assume unchanged demand for drugs, it will be necessary to provide for an additional amount of around RSD 2.2 billion in 2013 only for the purchases of drugs by foreign manufacturers. This amount should be further increased by at least a billion dinars on the conservative assumption that the share of the import

component in the production of domestic drugs is around 50%.<sup>36</sup> Consequently, the Fiscal Council's estimate is that it will be necessary to set aside at least RSD 3 billion more in 2013, for the purchase of the same quantity of drugs as in 2012.

**According to the estimate of the Fiscal Council, in 2013 it is possible to expect a further rise in expenditure for purchases of drugs and medical equipment, amounting to RSD 3-5 billion.** The adjustment of the accounting rate of exchange for drugs can be expected to cause an increase in RHIF expenditures in 2013 by around RSD 3 billion, with contingent further expenditure of RSD 1-2 billion arising from the enlargement of the positive drug list. Considering the fact that the adjustment of the exchange rate will continue in the coming period, and that the positive drug list has a tendency to grow further, new arrears on this basis can be easily generated in the health care system very soon. In order to prevent that, it is necessary to consider adequate austerity measures and spending controls in RHIF. Savings could be made by centralizing the procurement of drugs, better control of prescription drugs (priority to cheaper drugs) and better control of drugs which are included in the positive drug list. Better controls of collection of contributions for mandatory social insurance by the competent institutions are also needed. Finally, the government should make it clear to health care institutions that it will not tolerate the generation of payment arrears in the future, fix clear deadlines for settlement of liabilities and set payment priorities. The program for reforming the financing of the health care system, which would include all the above elements, should be defined not later than by end-2012, in order for its implementation to start as early as Q1 2013.

#### ***Arrears in the public sector***

Public sector arrears on a consolidated level are estimated to amount to around RSD 50 billion, with even 32.5 billion of them standing for health care system. Based on available data, the Republic Health Insurance Fund owes around RSD 17.5 billion for medicines and medical instruments. Health care institutions (hospitals and community health centers) owe additional RSD 15 billion, primarily for medicines. Local self-governments' debts are estimated to amount around RSD 13 billion, 8 billion of them for capital expenditure. Finally, it is also known that there are arrears in road construction industry amounting to around RSD 2-3 billion. In addition, at this moment, no one can guarantee that there are no other arrears as well. For example, there is no notion of the situation in the Environment Protection Fund which has been disestablished and of the level of their arrears. One should also bear in mind that the given arrears do not include possible liabilities of public enterprises which could easily be transferred into public debt, in case it is proved these cannot be covered.

**Settling the arrears will contribute to solvency growth in the economy and will create a basis for establishing order in the dynamics of public sector liability settlement.** We consider the intention of the Ministry of Finance and Economy and the Ministry of Health to assume the liabilities of hospitals as a public debt, with certain discounting, to be inevitable. We also think that this is the first step towards settling the issue of arrears in the health care system. The Ministry of Finance and Economy should prepare a plan on how these arrears will be covered without endangering the planned budget deficit next year. At the same time, these arrears must not hinder the sustainable path of the public debt proposed in the Fiscal Strategy. In order to meet these two conditions, the funds for arrears settlement in 2013 must not exceed 0.5% of GDP. On the other hand, we think that local self-governments should cover their arrears

<sup>36</sup>This is in line with the analysis of representatives of associations of local drug manufacturers, which claim losses of around EUR 30 million in the last three years on account of exchange rate differences.

from the funds allocated to them during the fiscal decentralization process.<sup>37</sup> Thereby, even in the first half of 2013, the conditions would be created for settling all public sector liabilities without delay.

**In parallel to settling arrears, it is necessary to envisage control mechanisms and processes which would prevent from new public sector delays.** First of all, there should be a better control over expenditure with budget beneficiaries, but, also, in local self-governments, public enterprises and state-owned companies. Centralisation in procurement of medicines in the health care system, limitation of funds allocated for wages and subsidies on the local level and strict control over employment are just some of the methods how delays could be prevented in the future. Until the end of 2012, or, in the first quarter of 2013 at the latest, competent ministries should draft a credible plan for prevention of new delays. Otherwise, if the state continues assuming the arrears, it will send a very bad message to budget beneficiaries. The message would say they should waste even more funds and create arrears, since, anyway, the state will cover them from the budget in the end.

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<sup>37</sup> For more details, please refer to the Chapter "Establishment of a sustainable system of fiscal decentralisation" in the text "Opinion on 2013 Draft Fiscal Strategy with projections for 2014 and 2015".