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PUBLIC FINANCE IN SERBIA: WHAT CAN COMPANIES EXPECT?

Javne finansije Srbije:
čemu privreda može da se nada?

Abstract

Companies expect low taxes, adequate budgetary support and contribution to the stability of fiscal and financial system from the public sector. The current public finance performs none of the three tasks in an adequate manner. First, public consumption in Serbia is high and inappropriate. The quality of service, which the public sector provides the economy with, is not satisfactory. Second, the structure of public expenditures is unfavorable. Current expenditures, and salaries and pensions within these, have an advantage, while, on the other hand, a sharp reduction in capital expenditures is implemented and further projected, as well as reduction in subsidies and government loans, and in the purchases of goods and services from the budget. Third, public finance does not improve financial stability. The state is a strong competitor to companies in the financial market, and both the legal and the economic limits of the public debt are reached. As part of the required public sector reform, it will be necessary first for the state to seriously demonstrate to the economy that, through the reforms of health, education, public administration, public companies and pension system, as well as through regulation of business environment and grey economy, the conditions and costs of business operations will be more favorable in future. Then, the tax reform would also be easily accepted by the economy and by the citizens.

Key words: *public finance, budget, financial stability, taxes, public consumption, reforms*

Sažetak

Preduzeća od javnog sektora očekuju niske poreze, odgovarajuću budžetsku podršku i doprinos stabilnosti fiskalnog i finansijskog sistema. Sva tri zadatka aktuelne javne finansije ne obavljaju na odgovarajući način. Prvo, javna potrošnja je u Srbiji visoka i neodgovarajuća. Kvalitet usluga koji javni sektor pruža privredi nije na zadovoljavajućem nivou. Drugo,

struktura javnih rashoda je nepovoljna. Tekući rashodi, a unutar njih plate i penzije, imaju prednost, dok se, s druge strane, sprovodi i planira oštro smanjenje kapitalnih rashoda, subvencija i državnih pozajmica, kao i kupovina robe i usluga iz budžeta. Treće, javne finansije ne unapređuju finansijsku stabilnost. Država je snažan konkurent preduzećima na finansijskom tržištu, a dostignuta je i u zakonska i ekonomska granica javnog duga. U sklopu potrebne osmišljene reforme javnog sektora, biće potrebno da najpre država pokaže ozbiljnost i da svebuhvatnom reformom pokaže privredi da će uslovi i troškovi poslovanja ubuduće biti povoljniji. Tada bi i poreska reforma bila lakše prihvaćena od strane privrede i građana.

Ključne reči: *javne finansije, budžet, finansijska stabilnost, porezi, javna potrošnja, reforme*

Introduction

This paper examines the extent to which public finance burdens the economy, helps the economy and ensures macroeconomic stability for the companies' business operations. The first part of the paper deals with Serbia's fiscal position and analyzes the dynamics of budget deficit and of the public debt, with an appropriate international comparison. The second part presents the ways in which the structure of public expenditures adapts during the budgeting in the crisis period. Finally, the last part introduces the medium-term framework of public finance in Serbia, which indicates that further absence of reforms will aggravate the position of economy in the next few years.

The fiscal position of Serbia

In the years before the global economic crisis outbreak, Serbia faced two divergent characteristics: low level of public debt (about 30% of GDP) and growing budget deficit (from the surplus in 2005 the deficit of 2.6% of GDP was reached in 2008). The low level of public debt led to a facile borrowing in the years following the crisis outbreak (from 2008), even though the growing deficit warned of an undoubtedly intensive increase in public debt. In the period after 2005, fiscal policy was expansionary and resulted in increasing expenditures and decreasing revenues. Taxes on income were reduced as well as the taxes on the transfer of absolute rights, certain products were transferred to a lower VAT rate, customs duties were reduced in the EU accession process, public sector wages and pensions rose before and after the elections, National Investment Plan and plentiful subsidy programs were launched. The crisis led to a sharp reduction in public revenues, but restriction of expenditures through freezing of wages and pensions was late (initiated only since 2009).

The high fiscal deficit was financed largely by borrowings, so the public debt intensely increased. Since late 2008 till the end of 2011 Serbia's public debt increased by EUR 5.7 billion, i.e. from 30% to 45% of GDP¹. We can conclude that the expansionary fiscal policy led to high budget deficits and, finally, to the explosive growth of public debt.

Regional overview (Table 2) shows that the public finance development in years of the crisis could be different.

1 Actual public debt of the general government was even higher in late 2011 (by about 2% of GDP), given that the percentage above-mentioned, of something less than 45% of GDP, should be also increased by non-guaranteed debt of local self-government and by budget beneficiaries' arrears (which, according to the Law on public debt, are not covered by the of public debt definition).

There were countries in the region that, back in 2009, had significantly higher budget deficits than Serbia, but most of them made efforts in the period of three crisis years to considerably reduce the deficits². With the exception of Bulgaria and Croatia, there is no state in which the deficit is not reduced compared to 2009, as is the case in Serbia. When it comes to public debt, Serbia's public debt is publicly often compared to the Maastricht criteria of 60% of GDP. However, Table 2 shows that the level of debt in less developed European countries is generally much lower than 60% (on average 39.3% of GDP) and that it cannot be said that Serbia is in a group of low-indebted countries.

High public consumption is a burden on the economy, since there is a constant pressure to use the fiscal and quasi-fiscal levies in order to provide funds for high public expenditures at all levels of government³. In addition, the public sector is inefficient and does not provide the economy with satisfactory services. The economy cannot be satisfied with the structure of public consumption as well. Capital expenditures of the central government account for less than 5% of total public expenditures, which is extremely low for a country that needs to build and modernize its infrastructure. Subsidies and net lending reported a share comparable to other countries (6% and 3% share in total expenditures), but the trends in this area are devastating, as will be discussed in more detail below.

Actual moment of Serbia's public finance

During the 2011 budget revision (as of September last year) and upon drafting the budget for 2012, it has become clear

2 It is likely that the final data for 2011 for most countries will show somewhat poorer statistics than the given forecasts of October 2011.

3 National Alliance for Local Economic Development (NALED) identified more than 250 quasi-fiscal levies.

Table 1: Serbia: general government revenues, expenditure, balance and public debt, 2007-2012 (Percent of GDP)

	2005	2006	2007	2008	2009	2010	2011*
General government revenues	43,0	44,2	44,0	43,0	42,3	41,0	39,1*
General government expenditures	42,0	45,8	46,0	45,6	46,7	45,5	43,7*
General government balance	1,0	-1,6	-2,0	-2,6	-4,5	-4,6	-4,6*
Public debt	52,2	37,7	30,9	29,2	34,8	42,9	44,8**

Source: Ministry of Finance; * estimate, ** data as of late November 2011.

how the budget of Serbia is prepared in the conditions of the narrow maneuvering space. We will mention only those elements that can be evaluated as forced and harmful from the standpoint of the interests of growth and economic development. Common to both cases is that, in terms of public revenues drop (due to the weakening of economic activity) and of increased expenditures for salaries and pensions, the savings are reported in both the expenditures where this is not desirable, and, at the same time, the savings are avoided where possible.

Lessons from the revised budget for 2011, adopted in September, are related to capital expenditures and funds that the budget beneficiaries exercise in addition to budget funds (own-source revenues).

In 2011, current budget expenditures increased above the original ones, projected in the budget, due to increase in wages, pensions and social expenditures (totaling about RSD 18 billion). The projected increase in allocations resulted from objective and legal circumstances – inflation higher than that projected in 2011 and a high indexation of the given public expenditures. In order to create the room for the increase in expenditures, the capital expenditures were sacrificed by the supplementary budget. The supplementary budget, in fact, projected capital expenditures at about RSD 8 billion less than the originally projected expenses. Failure to execute the capital

expenditures during the year and then to reduce capital expenditures projected by the revision, was an extremely negative result of economic policy in 2011. Development and equitable intergenerational distribution of fiscal burden depend on the investment and, in that sense, it is important to ensure greater level of execution and more budget resources for capital expenditures.

Another savings in the last quarter of 2011 (in the amount of RSD 9 billion) are projected in such a way that the amount of the own-source revenues (earmarked taxes, fees, etc.) should be larger than the amount of their spending⁴. Much of the personal income consists of levies that the economy pays to state funds (agencies, ministries, etc.) for clearly defined purposes of social significance. Savings in these budget positions can mean either that the burdens to the economy on these grounds are too large and that they should be reduced or that the relevant budget beneficiaries do not fully comply with their social role.

In drafting the budget for 2012, increase in spending on public sector wages and pensions had to be re-enabled, but now even in a worse situation – in the conditions of lower revenues at the central level after transfer of the income tax portion to the local level.

⁴ Savings are projected for the following beneficiaries: RSD 5.15 billion with the *Environmental Protection Fund*, RSD 2.15 billion with the *Budgetary Water Fund of the Republic of Serbia*, RSD 0.2 billion with the *Ministry of Justice* and RSD 1.5 billion with the *Treasury*.

Table 2: Emerging Europe: evolution of public debt and general government balance, 2009-2012 (Percent of GDP)

	General government balance			Public debt		
	2009	2010	2011	2009	2010	2011
Latvia	-7.8	-7.8	-4.5	32.8	39.9	39.6
Lithuania	-9.2	-7.1	-5.3	29.6	38.7	42.8
Hungary	-4.5	-4.3	2.0	78.4	80.2	76.1
Poland	-7.3	-7.9	-5.5	50.9	55.0	56.0
Bulgaria	-0.9	-3.9	-2.5	15.6	17.4	17.8
Romania	-7.3	-7.9	-5.5	50.9	55.0	56.0
Albania	-7.4	-4.2	-3.7	59.8	58.2	59.4
Bosnia and Herzegovina	-5.5	-4.3	-3.0	35.9	39.7	39.6
Croatia	-4.1	-5.0	-5.7	34.5	40.6	47.5
Macedonia, FYR	-2.7	-2.5	-2.5	23.8	24.6	26.5
Montenegro	-6.5	-3.8	-3.4	40.7	44.1	43.1
Serbia	-4.5	-4.6	-4.6	38.2	44.9	44.1
<i>Emerging Europe</i>	-6.2	-4.5	-2.1	30.5	40.1	39.3
<i>EU</i>	-6.7	-6.4	-4.5	74.3	79.8	82.3

Source: IMF, Regional Economic Outlook: Europe, October 2011

In preparing the budget for 2012, increase in wages and pensions imposed *ad hoc* adjustment again. It is obvious that the pronounced reduction in expenditures for the purchase of goods and services, as well as for subsidies and net lending was due to the fact that most of the budget expenditures were pre-defined by legal obligations of the state (Budget System Law) and by obligations to repay public debt. Compared to budget expenditures in the supplementary budget for 2011, increase in spending on pensions and wages was projected in the amount of RSD 30 billion, and increase in interest expenditures in the amount of RSD 17 billion. The projected increase in expenditure on wages and pensions complies with the Budget System Law while the increase in interest complies with the contractual obligations of the Republic. Therefore, discretionary budget expenditures had to be reduced. The biggest drop, of RSD 17 billion, was projected for the expenditures for acquisition of financial assets (net lending). Less expenditures, compared to 2011, were also projected in capital expenditures (by RSD 800 million), in the procurement of goods and services and in other current expenditures (by slightly over RSD 4 billion).

As for the projected direct support of the government to the economy in 2012, handling of subsidies and government loans (net lending) in the 2012 budget should be considered. Expenditures for subsidies and net lending are lower in the 2012 budget than in the budget revision for 2011, by about RSD 9 billion. In addition, subsidies increased by RSD 8 billion and net lending decreased by RSD 17 billion. It should be noted that the increase in subsidies results from methodological changes in the budget, but not from actual increase in subsidized funding for the economy. First, the budget contains subsidies allocated for roads for the first time (RSD 9 billion), as a result of changes in the collection of excise taxes and, consequently, the method of funding the PE "Roads of Serbia". If we exclude this new item from the budget, subsidies would actually amount to about RSD 1 billion less than in 2011. Second, certain expenses were previously credited as net lending, but are now credited as subsidies (subsidized loans for liquidity and investment of special significance – FIAT). Since the coverage is changed, the summarized expenditures for subsidies and net lending are not directly comparable with

the last year's, and must be observed in individual items. Thus, subsidies for the railways should be reduced by RSD 3 billion (from 16 to 13 billion), corporate subsidies by RSD 1 billion. Subsidies to public enterprises decreased by RSD 1 billion, subsidies for tourism by RSD 200 million, while subsidies for culture decreased by RSD 120 million. On the other hand, budget subsidies for agriculture are projected to remain at almost the same level as in 2011 (about RSD 20 billion).

It must be emphasized again that the risk of spending the budget beneficiaries' own-source revenues exists in 2012 as well. A great part of public administration: ministries, funds, administration units, agencies, and the like generate their own income from various fees, taxes, penalties, and other sources. The manner in which these funds are used and displayed in the Budget Law is not in accordance with good practice of managing public finance. Apart from the budget beneficiaries' own-source revenues, earned during the year (the projected amount in 2012 is RSD 71 billion), sources of their additional income are numerous: unspent income from the previous year, grants from various domestic and foreign sources, borrowing at home and abroad, sales of assets and others. The projected framework for the budget beneficiaries' additional income in the 2012 budget (RSD 136 billion) is almost twice the own-source revenues (RSD 71 billion).

Transparency of the Republic budget is reduced by inadequate budget review in terms of sources and of the budget beneficiaries' own-source revenues spending. The most important aggregate budget tables are flawed due to the fact that they only display the Republic budget expenditures in the narrow sense. In other words, the expenditures funded from the budget beneficiaries' own-source revenues and other additional sources are not displayed. Non-transparent public finance and non-transparent economic policy arise as a result. Interpretation of the projected expenditures of individual ministries is difficult, even wrong, if the expenditures to be financed from the funds and agencies under their jurisdiction are not taken into account. The Ministry under the auspices of which most of own-source revenues is realized, is the Ministry of Agriculture, Trade, Forestry and Water Management. In 2012, in addition to RSD 23 billion of

funds projected from the Republic budget (approximately the same amount as in 2011), the budget beneficiaries' additional funds are projected as source of funding in the amount of RSD 26 billion. In addition to about RSD 20 billion of budget subsidies (also shown in the Table in Article 1 of the Budget Law), the amount of more than RSD 15 billion of additional subsidies is projected to be funded from the budget beneficiaries' additional sources under the auspices of the Ministry of Agriculture, Trade, Forestry and Water Management. More drastic is the situation with the Ministry of Environment, Mining and Spatial Planning, for which slightly more than RSD 5 billion of budget sources is projected for 2012, but also more than RSD 12 billion of the budget beneficiaries' additional sources (agencies and funds) under its auspices.

An important change in the 2012 budget is initiated by the so-called fiscal decentralization. Due to amendments to the Law on Financing Local Self-Government there was a large imbalance in the revenues and expenditures at various levels of government. The Republic level of government will lose about RSD 40 billion (1.1% of GDP) in 2012, which accounts for the net effect of the application of the Law on Financing Local Self-Government. Revenues of the local level of government will increase for the same amount. In order to compensate for the loss on this ground, discretionary expenditure items of the Republic budget were forcibly reduced. Expenditures for the purchase of goods and services, subsidies and net lending decreased in 2012 in nominal terms compared to 2011, by as much as RSD 25 billion. According to the projections, an additional RSD 15 billion for the budget of the Republic should be provided from one-off revenues of the companies in bankruptcy – the residual claims of the state shall be collected from the bankruptcy estate. Projected savings will be hard to maintain and it is possible that it will result in increase in arrears in the payment of liabilities. In addition, it is not possible to permanently count on the income from the companies' bankruptcy estate, even if achieved in the projected amount, so the measures must be taken to systematically solve the emerging problem of lower income of the Republic.

Possible changes in the current system of public finance

The general public believes that the reduction in public consumption is possible if the number of employees in public administration is reduced and if the various agencies are abolished. Changes in these areas would be modest without serious reform of education, health, police, and military services. On the other hand, the prior discussion makes it clear that the existing system can achieve significant savings in two ways: by changing the concept of the budget beneficiaries' own-source revenues and by transferring certain public functions to the level of local government.

Inadequate handling of budgeting, reporting, and spending of the budget beneficiaries' own-source and other additional income have several consequences. First, expenditures and general government deficit may break the projected boundaries, by which the process of fiscal consolidation at the central government level becomes pointless to a certain extent. High consumption of the budget beneficiaries' funds in 2012 may contribute to a 0.5 p.p. of deficit increase above the level of 4.25% of GDP. Second, we cannot clearly consider the annual resources available to the Ministries – only the funds allocated from the budget are clearly displayed, but not their own-source or other additional funds of the budget beneficiaries (those funds happen to exceed the budget funds manifold). Third, the implemented economic policy is vague – the structure of public expenditures (mostly subsidies) can be fully considered only if own-source revenues are transparently integrated into budgeting process. Fourth, spending of the budget beneficiaries' revenues cannot be reliably monitored during the year, due to, a broad, uncontrolled, framework for the spending thereof, on the one hand, and unreliable control mechanisms (arising from the legal and factual autonomy of budget beneficiaries) on the other hand. Fifth, further violation of the public finance transparency principles is possible: incentives increase to set up special budget beneficiaries (funds and agencies) that will be able to provide sufficient funds for the desirable expenditures of the relevant ministries. Sixth, the dispersed system of autonomous budget beneficiaries

leads to increasing para-fiscal levies (different taxes and fees), thereby increasing the burden on the economy and on the citizens.

Therefore, justification of certain forms of the budget beneficiaries' own-source revenues should be reviewed in future, as well as the possibilities of integrating a portion of those revenues with the core budget of the Republic of Serbia. This possibility should be considered since the funds saved in the current year practically do not flow into the Treasury but are transferred for the same purpose to the next year. Substantial savings are not generated in this way, but, actually, spending from the own-source revenues is only temporarily delayed. Opportunities to assess the necessity and the amount of various quasi-fiscal levies from which these funds are financed should also be considered, along with the possibilities of greater budgetary disposal of funds collected in this way.

It is also necessary to consider changes in the relations between the central government and the local government. In 2012 local authorities shall increase the liabilities on the expenditure side of the budget, by about RSD 15 billion. This is, in fact, the amount of liabilities the local government takes on for maintenance of local road infrastructure that was previously under the jurisdiction of the PE "Roads of Serbia" (about RSD 10 billion) and local investment projects that were previously conducted by the former Ministry for NIP (about RSD 5 billion). Local self-government should use the additional funds allocated in 2012, thanks to fiscal decentralization, by paying the accumulated arrears by the first half of the year (either directly or through local public companies), which would also have the desirable antirecession effect on the economy. During the second semester of the year, the new government should take steps as soon as possible to redirect a part of the local government jurisdiction from the republican level of government, probably in the area of social protection (material support to families, parental allowance, etc.). The basic idea of the proposed model of redirection is to comprehensively use the current administration, and for the local level of government to participate, to appropriate percentage, in financing social benefits for beneficiaries in their territory. In this way, reduced efficiency of public administration will be avoided,

and non-productive increase in local administration employment would be prevented.

Public finance in the medium term

First, something should be said about the dilemma of whether to increase the legally defined limits on budget deficits and on public debt. In fact, according to certain viewpoints, reduction in deficit and in public debt cannot be insisted on during the crisis since – according to the Keynesian approach – the government must maintain demand and economic activity at a higher level by increasing both the deficit and the debt. Unfortunately, there is no room for application of this viewpoint in Serbia. Contrary to developed countries, Serbia cannot count on an almost unlimited financial support to scarce public finance. The total funds needed to finance the fiscal deficit and public debt principal in 2012 amount to about EUR 5 billion (deficit of EUR 1.5 billion and repayment of the public debt principal of EUR 3.5 billion). Part of the liabilities can be funded from the existing deposits on Treasury account, part of these funds could be secured by refinancing matured short-term debts arising from securities, but the remaining amount, necessary for financing fiscal deficit and due debts, is high and amounts to about EUR 2.3 billion.

Given the amount of funds necessary for financing deficit and liabilities, as well as the situation on international financial markets, problems may arise in early 2012 in financing the needs of the government. The current wave of public debt crisis in Europe has made investors distrustful and cautious so they now respond by refusing to finance the public debt of a country, at a much lower level of debt relative to GDP than was previously the case. The greatest risk Serbia can face is the situation at some point in time, which is not exactly predictable, in which the investors can estimate that Serbia is insolvent, and then can refuse to fund the needs of the state, which would mean entering a debt crisis. Serbia is particularly vulnerable to the possibility that investors can refrain from refinancing government securities, i.e. that the funds due are not reinvested in treasury bills. The last relevant international analyses indicate the possibility that, in the absence of liquidity, banks from the eurozone will begin to

withdraw their capital from Central and Eastern Europe. Therefore, due to difficulties in funding the liabilities in 2012, it is almost impossible to use anti-cyclical fiscal policy (increasing the deficit and debt) to respond to the worsening of economic trends.

Government presented its medium-term plan on public finance in the Fiscal Strategy Report (previously known as the Memorandum on the Budget and on Economic Policy). According to the Fiscal Strategy Report for 2012 with projections for 2013 and 2014, we can consider the fiscal framework for the next three years. Based on this plan, it is obvious that decisive initiation of comprehensive reforms is necessary in order to bring about public expenditures cuts and increase in public revenues, because, otherwise, the public debt crisis could arise in the medium term. Due to a slowdown in economic activity in 2011 and a 1.5% of the projected low growth in real GDP in 2012, public debt will break the legal limit of 45% of GDP and, if the credible measures for a curbing thereof are not taken, it will continue to grow in 2013 and 2014. With such an upward trend in public debt Serbia will probably exceed not only legal limit of public debt but also the economic one, after which the investors will refuse to finance fiscal deficit and to service the existing public debt – i.e. Serbia will enter the public debt crisis. This means that the medium-term fiscal policy needs to be more restrictive than the one projected for 2013 and 2014 by the fiscal framework of the Fiscal Strategy Report. However, even the insufficiently restrictive fiscal framework could not be achieved in 2013 and 2014 with the current fiscal policy. It is therefore necessary to initiate comprehensive reforms as soon as possible, on both the expenditure and the revenue sides of the budget.

Decrease in the budget deficit, to 3.7% of GDP in 2013 and to 2.9% of GDP in 2014, was projected in the Fiscal Strategy Report. These deficit values are derived on the basis of the fiscal rules formula that defines the allowable amount of the budget deficit. The following assumptions are used: first, the fiscal deficit to be realized in 2012 will amount to 4.25% of GDP; second, the real GDP growth in 2013 will amount to 3% and in 2014 to 4%. The projected fiscal adjustment (i.e. the fiscal deficit reduction) in the medium term is carried out only through the expenditure

side. Proposal on the Fiscal Strategy Report stipulates the fiscal adjustment of 1.7 p.p. of GDP (from 4.5% to 2.9% of GDP) in the period 2011-2014, whereby this adjustment will mostly be realized (1.6 p.p. of GDP) through reduction in public consumption. The substantial increase in public revenues was not planned (public revenue will increase, as projected, compared to GDP by 0.1 p.p. of GDP).

On the expenditure side, continuation of the sharp reduction in subsidies is projected, as well as is reduction in expenditures for goods and services, and in net lending. The largest expenditure items – the public sector pensions and wages – are defined by fiscal rules, and their share in GDP gradually reduces, which is also projected in the Fiscal Strategy Report. However, this reduction will not be sufficient to ensure the necessary adjustment of budget expenditures, so the Fiscal Strategy Report stipulated a sharp, medium-term decrease in the share of certain expenditure-side items in GDP. The priorities are allocations for the purchase of goods and services (a decrease of 1.1 p.p. of GDP) and subsidies (a decrease of 0.5 p.p. of GDP). The anticipated lending dynamics indicate the same low share in GDP as in the year of 2012. It will be very difficult to achieve such big savings.

More importantly, the proposed structure of public expenditures, even if achieved, is not desirable for the achievement of fiscal and development policy goals since the projected level of capital expenditures does not correspond to the country's development needs. Anticipated budget framework does not leave enough room for growth in capital expenditures. Only in 2012, a real increase in public expenditures is estimated to be higher than the GDP growth. In addition, their share in the public expenditures shall increase, while the dynamics in 2013 and in 2014 shall be unfavorable in terms of both growth (even a real decline is projected in 2013) and of their share in public expenditures. Such movement of capital expenditures is inconsistent with the country's development needs and with the imperative to increase the low share of capital expenditures in the structure of public expenditures.

If observed in the medium term, it is necessary to provide most of the fiscal adjustment through reduction in current public expenditures. Estimated share of public

expenditures in GDP, of about 44.2% of GDP in 2012, of which over 40% of GDP are current public expenditures, is very high. Therefore, a key strategic goal of the state should be a permanent reduction in the share of current public expenditures in GDP, while a possible increase in public revenues should be of secondary importance. The time limit within which the current expenditures should be reduced is an additional restriction since estimates indicate an unsustainable increase in public debt if fiscal adjustment is not initiated as soon as possible.

Given that over 70% of expenditures is regulated by law or by liabilities (such as interest payment on public debt), the government's playing field for possible savings in the short term is small. If, however, the preparation of credible reforms is initiated and, on the bases thereof the amendments to existent laws commenced in early 2012, it is possible to improve the public sector efficiency in the short term as well as to adjust total public consumption with economic possibilities of the country. Timely systematic reduction in public consumption, compared to GDP, would have a vital contribution to the prevention of debt crisis. Sufficient savings in the current expenditure items are only achievable through systemic structural reforms, aimed at the largest expenditure items of the budget: reform of health and education sectors, streamlining of public administration, establishing of a sustainable system of fiscal decentralization, rationalization of public enterprises and continuation of pension reform.

A comprehensive tax reform will probably be necessary. It will probably have a net effect of the public revenues increase. Despite the fact that the most important tax rates remained unchanged, there was a reduction in the public revenues share in GDP in recent years. The said change was the result of the change in structure of economy at the expense of consumption decrease. Given that similar trends are likely to continue in the future, it is necessary to initiate a comprehensive tax reform that will, in the aggregate effects, lead to a certain increase in public revenues. Within such reform, VAT revenues would increase, as well as revenues from property tax and income tax revenues, while the fiscal burden on employment would decrease and a number of quasi-fiscal levies would also decrease or would be terminated.

Apart from desirable fiscal implications, these changes would also have a positive effect on the improvement of business environment.

Conclusion

Companies expect low taxes, adequate budgetary support, and contribution to the stability of fiscal and financial system from the public sector. The current public finance performs none of the three tasks in an adequate manner. The paper discusses the present and the future perspective of the Serbian public finance in light of the given aspects of relationship with the economy. The conclusions are as follows:

First, public consumption in Serbia is high and inappropriate. The level of public revenues and expenditures, of 40% to 45% of GDP, does not deviate from the (high) European standards, but the declining trend in revenues, increase in expenditures, growing deficit and public debt increase are of most concern. The quality of service that the public sector provides the economy with is not satisfactory, which is equally bad as the abovementioned. In other words, it means in our case that the expensive state does not imply the state of high quality.

Second, the structure of public expenditures is unfavorable. The last two budgetary procedures (the supplementary budget for 2011 and the budget for 2012) indicate that the current expenditures, and wages and pensions within them, are undisputed. There are also growing liabilities to interest payment. Other groups of expenditure are mainly adjusted to the expenditures given below, in order to provide room for increased wages, pensions, and interest. Thus, the first in a row in 2011 were capital expenditures that additionally decreased from the already low levels. It is clear that this undermines the preconditions for rapid future growth and development. Furthermore, sharp reduction in public expenditure subsidies and government loans, as well as in purchase of goods and services from the budget, are projected as from 2012 further on. It goes without saying that the share of capital investment further decreases. The structure of public revenues in the period 2012-2014, anticipated by the government program, will probably be unsustainable but –

even if it is sustainable – it will be considered undesirable, especially from the development standpoint. The economy will not be able to count on direct government assistance (through grants and loans), or on the indirect effects (through public procurement), or even on the healthiest form of development aid – investment.

Third, public finance does not improve financial stability. On the contrary, the state is a strong competitor to companies in the financial market since the borrowing (direct and through emission of securities) reduces the banks' potential for lending to the economy and raises interest rates. The effect of increasing borrowing on the possibility to preserve macroeconomic stability is even more important. Serbia hits the legal and economic limits of the public debt. The funds necessary for financing budget deficit and for paying due debts are increased to such an extent (about EUR 5 billion in 2012) that it is uncertain whether Serbia will be able to provide them. This problem is particularly complex in terms of the general crisis of public debt in Europe. If Serbia enters a public debt crisis, the economy will be exposed to tectonic changes in the foreign exchange market (high depreciation of the dinar), in the financial markets (high interest rates and capital shortfall), and in the area of macroeconomic stability (high inflation). In such situation, we could not even expect a modest economic growth.

Correction of previous deficiencies is impossible without fundamental reforms of the public sector. If this does not happen, the maneuvering space will barely sufficient. This paper addresses some of the suggestions

that are rarely discussed in public: the so-called budget beneficiaries' own-source revenues and transfer from the central government level to the level of local self-government. As part of the required public sector reform, it will be necessary first for the state to seriously demonstrate to the economy that, through the reforms of health, education, public administration, public companies and pension system, as well through regulation of business environment and grey economy, the conditions and costs of business operations will be more favorable in future. In that case, the tax reform, which would increase VAT revenue, property tax and income tax and which would reduce the burden on employment and regulate quasi-fiscal duties, would be more easily accepted by the companies and by the citizens. If the overall reform is reduced to VAT increase it would be a vulgarization of the concept that would be, rightfully, met with great opposition by the Serbian public.

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