

INTRODUCTION

1. This report responds to a specific request from the Serbian Minister of Finance. In the face of slowing economic growth, the Government faces the prospect of increasing deficits in the short and medium term, due largely to growing pension obligations. The problem cannot be addressed by increasing revenues: the public sector is already oversized. The Ministry of Finance has therefore asked the Bank to identify opportunities for constraining growth in expenditures, without sacrificing the quality of public services. This report is therefore focused on identifying opportunities for efficiency gains in the major categories of Government expenditure.

RECENT ECONOMIC TRENDS

2. Until very recently, Serbia's economy had been grown strongly, following significant economic reforms begun in 2000. As shown in Table 1, real GDP growth in 2007 reached 7.5 percent, the second highest since the start of the transition. Non-agricultural growth averaged 7.6 percent over the 2005-2007 period, driven by the services sector which had been growing at double digit rates (in particular trade, financial services and transport and telecommunication). Output rose by nearly 50 percent between 2000 and 2007, as the corporate sector started to post profits and the banking sector was restructured. The positive supply response also appears to reflect increases in productivity and output of recently privatized and *de novo* firms, as evidenced by the particularly rapid rates of output growth in precisely those sectors which have recently undergone extensive privatization (e.g., steel, cement, rubber, tobacco, dairy, sugar, and banking) or attracted foreign investors.

Table 1: Key Economic Indicators

	2005	2006	2007	2008	2009	2010	2011	2012	2013
<u>National Accounts</u>									
Real GDP growth (%)	6.0	5.6	7.5	5.6	-2.0	0.0	3.0	5.0	5.5
Revenue (% GDP)	42.8	43.6	43.0	40.9	39.5	38.3	37.9	37.6	37.5
Expenditure (% GDP)	42.0	45.2	44.9	43.4	42.5	40.9	39.6	38.8	38.8
Balance (% GDP)	0.8	-1.6	-1.9	-2.5	-3.0	-2.5	-1.7	-1.2	-1.2

Source: IMF. Data for 2008 are preliminary.
Data for 2009 and later are projections

3. Rapid growth during 2005-07 was led by domestic aggregate demand. Overall investment levels had remained roughly constant in recent years, and slightly increased to 24.4 percent of GDP in 2007, although public investment levels had been

rising from 2.7 percent of GDP in 2005 to 4.7 percent in 2007. Real private sector consumption had been growing rapidly and increased by nearly 10 percent in 2007 alone. It took place on the back of:

- ***a credit boom***: Serbia continued to experience rapid credit growth which for 2007 is estimated to be 16.1 percent (average for the year); driven by credit to households which grew by more than 51 percent in 2007 (average for the year);
- ***expansionary fiscal policies and significant increases in public spending***: Consolidated general government spending reached 44.9 percent of GDP in 2007, up from 42 percent in 2005, driven by increases in both capital and current spending;
- ***increases in real wage levels***: Total year-on-year real gross wages increased 17.9 percent in 2007, on top of a 12.1 percent increase in 2006;
- ***rapid increases in exports***: Exports increased on average 29.6 percent annually (in dollar terms) over the 2005-07 period, albeit from a low base.

4. The global economic crisis has hit Serbia hard. Growth in 2008 as a whole is estimated to have declined to 5.4 percent, with growth in the earlier part of the year driven by continued strong goods services sector performance, a much better agriculture season and growth in manufacturing and exports offset by declines later in the year. In the near term, the Serbian economy will continue to be affected by the international economic crisis, like other countries in the region. The Serbian economy to large extent depends on the availability of credit and investment from abroad, and receives annually about 9 percent of GDP in the form of remittances. As of May, 2009, the IMF estimated that in 2009 Serbia will see a two percent drop in GDP. Projections for the subsequent years (2010-2013) show a slow recovery, with no growth in 2010 and only three percent growth in 2011, based on ongoing developments in the global economy as well as new fiscal policies adopted in line with the Fund program. (See below.)

THE IMF STANDBY ARRANGEMENTS

5. Recognizing the risks inherent in the current international financial situation Serbia requested a precautionary stand-by arrangement (SBA) with the IMF in late 2008. In January, 2009, the Fund mission and the Serbian government reached agreement on a fifteen month economic program supported by a €402.5 million precautionary stand-by arrangement (SBA). This is now expected to be replaced by a new, 27-month, SBA, whose terms were broadly agreed upon in March, 2009.

6. The original 15 month SBA called for an overall fiscal deficit of 1.75 percent of GDP in 2009 and one percent of GDP in 2010. This was to be achieved largely through limitations on expenditures. (On the revenue side, the January SBA called only

for small increases in excise taxes to offset decreases in customs revenue resulting from the recently signed SAA pact with the EU.) In aggregate, Government revenue would decline slightly as a percent of GDP. Apart from these measures, all adjustments would take place on the expenditure side.

7. By far the most important adjustment was to be a temporary suspension of pension indexation. Pension levels would reflect the two large increases granted in 2008, but would not be increased during 2009. In addition, increases in public sector wages would be limited to the projected rate of inflation (7.9 percent). Non-essential hiring was to be suspended. Taken together, these measures were expected to confine growth in the wage bill to six percent. Public enterprises and local governments were expected to follow similar wage policies. The Government also committed itself to a freeze in most spending on other goods and services (in nominal terms) and reductions in agricultural subsidies, including the abolition of the per-hectare land payment to legal entities. Existing commitments to a joint venture project with Fiat and Zastava car company would be honored, however—an expenditure which the Government's accompanying Memorandum of Economic and Financial Policies (MEFP) estimated would cost .5 percent of GDP.

8. The new draft SBA calls for additional, more severe, measures. As specified in the Government's Memorandum of Economic and Financial Policies, these would include a freeze on the nominal wages of government employees (including employees of public enterprises) through 2010, an extension of the nominal freeze on pensions through 2010, a freeze on hiring (with very limited exceptions), a reduction in transfers to local governments, and sharp reductions in the discretionary budgets of all budget users.

9. These measures, while severe, are short term palliatives. The Government will not be able to freeze pensions in nominal terms indefinitely, as inflation will rapidly diminish their purchasing power. A long term freeze on salaries will make it difficult to attract and retain competent staff. Hiring freezes, by the same token, run the risk of generating arbitrary gaps in public employment, as staff who retire are not replaced. Cuts in discretionary spending--particularly for road maintenance--would result in further deterioration of the network.

10. While the eventual resumption of economic growth will generate some increase in revenues, the fiscal envelope over the medium term is expected to be tight. According to the Fund's projections, Government revenues are projected to decline by five percent in 2009, and a further four percent in 2010. Revenues would only begin to recover, in real RSD terms in 2011.

11. In any event, increases in government revenues are not sustainable in macroeconomic terms. The Serbian public sector is already oversized. Under these circumstances, the Government will therefore have to focus on continued restraint in expenditure. The aim of this Public Expenditure Review (PER) is to advise the Government—and more specifically the Minister of Finance—on opportunities for

constraining growth in expenditures, without sacrificing the quality of services it provides.

THE EXISTING DISTRIBUTION OF PUBLIC EXPENDITURE

12. The Serbian public sector consists of several distinct entities: (1) budgetary central government, which accounts for the majority of spending, including defense and public security, social assistance, and most of the costs of education; (2) the pension and health insurance funds and the road company, each of which has an independent source of revenue but also receives varying levels of transfers from the central budget; (3) local governments, which have limited taxing powers (as well as the authority to impose tariffs to support their public utilities) but receive substantial transfers from the central budget; and (4) centrally owned public utilities, state-owned, and socially-owned enterprises. This report focuses on a subset of these, namely entities: (1) over which the central government exercises direct fiscal control, and (2) that compete for central government tax revenues or their equivalent (e.g., payroll taxes). Thus it will focus on the budgetary central government, the pension and health insurance funds and the road company.¹ Local governments will be considered only to the extent they represent a claim on the central government budget—i.e., as recipients of intergovernmental transfers. State owned enterprises will be considered in the same way.

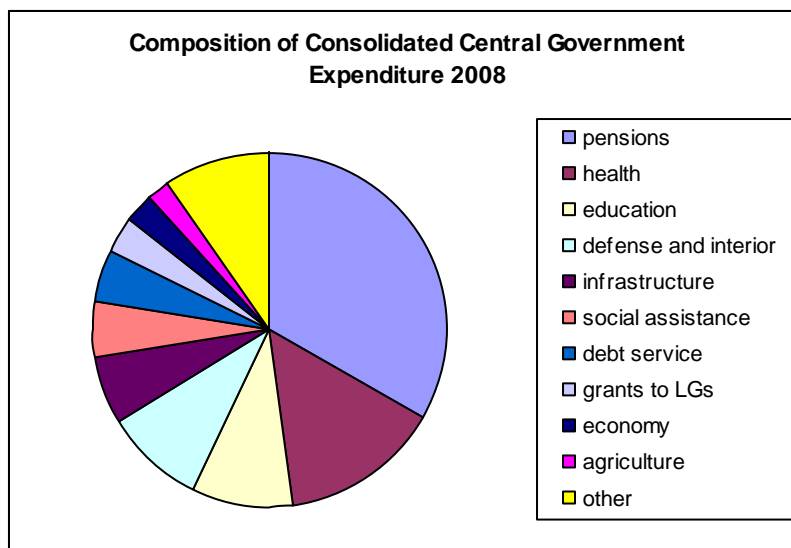


Figure 1

13. Figure 1 demonstrates the sectoral distribution of consolidated central government expenditures.² As shown, the largest single item of consolidated central government expenditure consists of pensions. Spending on pensions consumed one third of public expenditures in 2008. Spending on health (largely financed from social contributions to the HIF) is

¹ Although the pension funds and the health fund derive the majority of their revenues from payroll contributions, these function, in effect as taxes. Any increase in contributions paid to these funds reduces the amount of fiscal space available to the central government.

² Consolidated, as defined here, includes the expenditures of the pension and health funds and the road agency that are financed from their respective own-source revenues. Data is from budget execution reports of central government, HIF, pension funds and PEPS.

the second largest item of consolidated central government expenditure, accounting for 15 percent of the total in 2008. Spending on education consumed another ten percent. Spending on security--defense and police--also consumed about ten percent. Spending on transport infrastructure (including foreign financed-spending) and social assistance each consumed about five percent of the total. Taken together, these six major items of expenditure accounted for 78 percent of total consolidated expenditure in 2008. With the exception of security—where the World Bank claims no expertise—these sectors are the focus of this report. This report also examines spending on enterprise subsidies. Although these do not constitute a major proportion of government spending, they represent particularly attractive targets for expenditure cuts.

14. As shown in Figure 2, the 2009 budget (as revised effective May 2009) implies sharp changes in the sectoral composition of central government expenditure. (In the absence of budgets for the pension funds, the health fund, and the road agency, this analysis is based on budgetary central government only.) In absolute terms, expenditures on pensions—i.e., transfers to the pension fund—would soar. Expenditures on debt service, principally under the rubric ‘repayment of principal on domestic debt’, would increase by a nearly equal amount. Expenditures on defense and police would increase, as would expenditure on social assistance and programs administered by the Ministry of Economy. All other categories of expenditures would see either little growth or sharp decline.

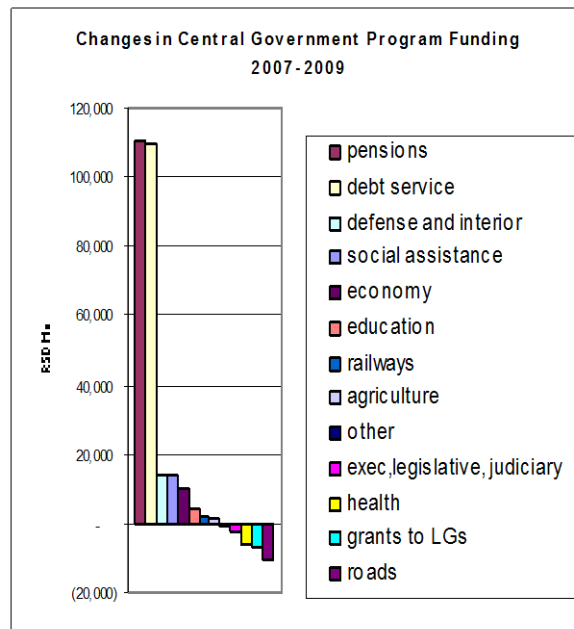


Figure 2