

reducing such benefits would presumably not be worth the political expense of doing so. No changes in veterans benefits are therefore recommended.

109. The same is true of the birth grant which has a strictly pro-natalist objective. It provides a grant for each child, with the amount increasing steeply with each additional offspring. The grant for a second child is four times higher than that for the first; the grant for the third, 1.75 times that for the second; the fourth 1.35 times that for the third. Although the objective of this grant could be questioned, it is relatively cheap. Overall, birth grants account for eight percent of social spending and only 0.15 percent of GDP (2008). It is therefore recommended that the birth grant be maintained at its current level.

110. The caregivers allowance targets people with disabilities. It was received by 3.1 percent of households in 2007 and by 7.2 percent of the poor households.⁵¹ The program could benefit from some redesign: consolidating some of the small and narrowly targeted elements (e.g., allowances for specialized equipment, transportation, rehabilitation, communications, etc.) into one benefit which reflects the individual medical and social inclusion needs of the recipient, and linking benefits with social care and employment services. This should be on the agenda for medium-term reform. But in fiscal terms, reform is not urgent. The caregivers' allowance accounts for only about 10 percent of spending on social programs and 0.19 percent of GDP.

ENTERPRISE SUBSIDIES

111. Subsidies to enterprises (including farms) constitute a significant proportion of government expenditure in the current period. The five largest central government programs consumed about four percent the 2008 central government consolidated spending in 2008, based on 2008 budget execution data.⁵² But the subsidy regime is in transition. A large proportion of subsidies have been used to facilitate the process of privatization, financing severance payments for workers in state owned enterprises. With some exceptions, the privatization process has been largely completed, and the level of these subsidies can be expected to decline. Under the revised 2009 budget, a considerable volume of resources are committed to new equity investments. These represent part of the Government's economic stimulus efforts, and might be expected to decline. What will remain are of subsidies to SOEs that have been slow to privatize--particularly in the mining sector--subsidies to the railroad and to agriculture, and subsidies to certain classes of private firms---such as SMEs. In the current economic climate, there is also pressure to make soft loans to private firms in order to stimulate the economy.

⁵¹ Living Standards Measurement Study. Serbia 2002-2007.

⁵² These figures exclude a variety of smaller subsidy programs and implicit subsidies in the form of write-offs of uncollected taxes and social contributions from state owned enterprises. They also exclude subsidies from local governments to their respective enterprises, which are financed from local government's general budgets.

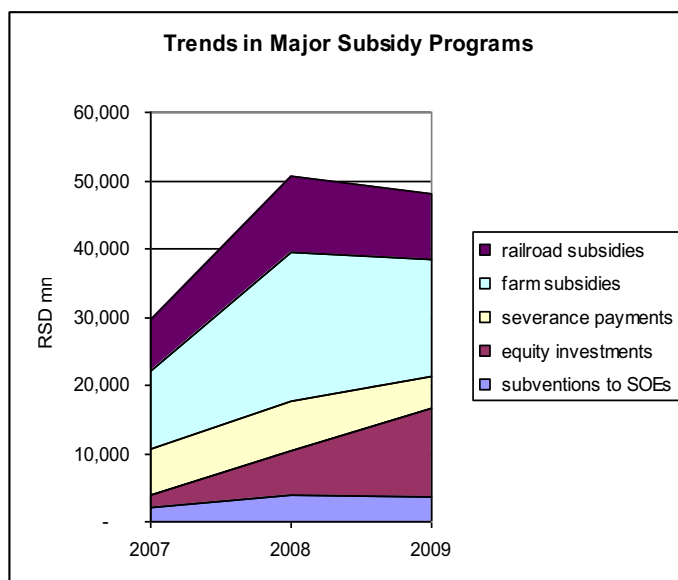


Figure 23

AGRICULTURAL SUBSIDIES

112. In sectoral terms, the largest program of subsidies consists of subsidies to agriculture. As shown in Figure 23, in 2008, these accounted for about 40 percent of total central government subsidies. Since 2004, Serbia has been phasing out price supports for specific crops. Sugar and tobacco subsidies have been eliminated, although support to

the dairying industry remains. But the largest form of agricultural

subsidies consists of the so-called ‘de-coupled area payment’. This was introduced in 2007 to replace former input subsidies and reflects the structure of subsidies under the EU’s Common Agricultural Policy (CAP). It consists of a standard payment (equal to € 120 per hectare) to every registered farmer, up to a maximum of 100 hectares. As of 2008, only full time farmers who contribute to the pension system are eligible to receive the subsidy.

113. As an alternative to input subsidies or price supports, the decoupled area payment is relatively efficient. It does not distort prices. But it is also expensive and—in the current Serbian context—difficult to justify. In effect, it functions as a poorly targeted form of social assistance for the rural population. Because payments are not means tested, there is presumably a high level of leakage to higher income groups. At the same time, the de-coupled area payment may be inhibiting agricultural productivity. The 100-hectare cap on benefits discourages land consolidation. Already, the average farm size in Serbia is less than one-quarter that in the EU.⁵³ Consolidation will be necessary to permit Serbian farmers to compete with those in the EU. International experience, moreover, suggests that investment in rural infrastructure (primarily irrigation and roads) and the dissemination of new existing technologies are much more effective in promoting agricultural growth than subsidies.

114. In principle, there is therefore a strong case for eliminating the decoupled area payment—at least until Serbia joins the EU. At that time, the costs of the program will be paid by Brussels. (Eliminating the program would not jeopardize Serbia’s

⁵³ The average farm size in the EU, including leased land, is 27 ha. According to the Serbian agricultural census, the average farm size in Serbia is 3.5 ha. This figure excludes leased land, however. Data from the farm registry suggests that the EU-comparable figure is closer to 6 ha.

accession prospects, as the EU requires only that the *system* for distributing the subsidy be accredited prior to the distribution of EU agricultural subsidies.) The program's role in supporting the incomes of poor farm families could be replaced by a scaled-up MOP, as noted earlier. Alternatively, **the program could be transformed into an income-support program for small farms**, with the area payment subject to means testing. The political obstacles to doing so should not be underestimated. According to the 2008 LFS, roughly one-quarter of the Serbian labor force is engaged in agriculture—an important constituency that would be expected to resist such reform. Nevertheless, the Government has managed to impose an across-the-board reduction in the area based payment in 2009 and may be able to further reduce it on a targeted basis in future years.

SUBSIDIES TO STATE ENTERPRISES

115. Support to state- and socially-owned enterprises (SOEs) that are due to be privatized constituted about 22 percent of central government subsidies in 2008. These include severance payments financed from the Development Fund, the Transition Fund and the Solidarity Fund, and credit lines to socially owned enterprises for restructuring. A large proportion consists of soft loans provided by the Development Fund and payments by the Transition and Solidarity Funds, which finance severance in connection with the pre-privatization staff restructuring.

116. Overall, the level of enterprise subsidies (excluding subsidies to railroads) has increased in nominal terms over the last four years, due to increased funding for severance. Costs are expected to decline however, as privatization proceeds. In 2008, 18 of the 20 largest SOEs were offered for sale. Nine were sold and one liquidated through bankruptcy. Altogether around 240 companies were sold through different privatization models. Indirect subsidies, in the form of tax and contribution arrears, have also been a problem, although the level of such subsidies is expected to decline as privatization proceeds. According to data from the Tax Administration, at the end of 2008 the overall stock of tax and contribution arrears of 987 public enterprises was RSD13.37 billion, of which twenty percent was owed by inactive companies.

117. The Government nevertheless confronts the costs of subsidizing or privatizing the more intractable state enterprises. In the mining industry, Resavica and Bor are the two largest remaining companies that are slated for privatization or closure. Resavica is the largest single recipient of central government budget subsidies in Serbia (other than Serbian railways). It is a complex of nine mines employing 4,195 people across 8 municipalities. Of the nine mines, a maximum of one-third are viable. (One mine has been out of operation since the late-80s.) Direct subsidies for Resavica in 2008 amounted to €22 million or 0.06 percent of GDP. The level of subsidies per employee is equal to average wage in the country as a whole. In addition to direct subsidies, Resavica receives implicit subsidies in the form uncollected taxes and social contributions. Rough estimates suggest that these indirect subsidies are almost equivalent to the direct ones.

118. Boor receives far less in terms of direct subsidies (a soft loan of RSD39 million) but still benefits from significant implicit subsidies. Bor's existing stock of debt to state and private institutions (the latter constitute a contingent liability for the state) amounted to a record €670 million in 2008. Out of this, arrears on taxes, social

Box 5: The Development Fund

In principle, the Development Fund exists to provide subsidized financing for the programs related to economic and regional development, development of SMEs, increasing competitiveness, and so forth. The average subsidized interest rate at around 6-7 percent compares favorably with the market average of some 15-17 percent in 2008. During 2007, the Development Fund approved 1,221 loans in the total amount of approximately €208 million or 0.89 percent of GDP.

In practice, a large part of Development Fund financing goes to socially-owned companies, where less than ten percent of loans are being repaid; the rest being written-off in the process of pre-privatization restructuring. These loans are used to cover operating costs—wages, electricity, gas, etc.—rather than a new investment—and reflect the unprofitability of the borrowers. In 2008, some €33 million was spent on 114 loss-making companies distributed across transport, metal, metallurgy, textile, chemical, electrical machinery, non-metal, construction, wood, tourism and other industries.

Source: Ministry of Economy, Development Fund.

contributions, and loan repayments due to the Development Fund amounted to €180 million. The Government embarked upon the privatization of the mines in 2006. Privatization advisers were hired and the company was prepared for privatization. However, the process has been stalled since then, particularly at Resavica. **The Government should restart the process, restructuring the company, closing the least viable mines, and launching a staff downsizing program.**

119. By far the largest privatization expenditure proposed in the initial 2009 budget was the Government's proposed equity investment in Zastava, a key component in the proposed sale of a majority stake in the company to FIAT. Although this was expected to reduce subsidies to firm in the long run, in the short run, it represented an extremely heavy cost. (The Government's proposed equity investment and loans to =Zastava were budgeted at RSD14 billion in 2009. This was equivalent to about RSD 230,000 per employee.) Due to changing economic conditions, the agreement with FIAT has not yet been signed, although FIAT has made some initial investments in the Zastava plant. Under the revised 2009 budget, the allocation for the Zastava project has been reduced to RSD4 billion, with the remainder of the funds allocated to several subsidized loan programs, including liquidity loans to export-oriented firms (RSD4.0 billion); start-up loans to small enterprises (RSD3.2 billion); and subsidized loans to consumers for purchases of domestically produced consumer durables (RSD2 million).

120. Looking forward, Serbia's enterprise subsidies have been justly criticized for distorting markets, undermining the country's long term competitiveness, and wasting money on non-economic enterprises. Serbia's EU ambitions, if not the force of these arguments, will eventually force it to scale back its remaining sector specific subsidies. The European Commission (EC) has adopted a "State Aid Action Plan for 2005-2009" which seeks a relative reduction of the overall state aid in GDP and reorientation of aid to address market failures, rather than supporting specific industries. In the new EU member states, subsidy reform has been a key component of the pre-accession and post-accession reform agenda. If Serbia is to follow this example, enterprise subsidies would have to be limited to development aid, R&D, closures, and staff reductions.

121. To this end, the Ministry of Finance is in the process of drafting a Law on State Aid. This is intended to be consistent with the EU state aid rules and the institutional arrangements and system of ex-ante control of state aid specified in Serbia's Stabilization and Association Agreement with the EU⁵⁴. The draft law, however, has scope for improvement. Under the current draft, the proposed Serbian Commission for State Aid Control would lie within the Government, being presided over by the Minister of Finance. All Commission members would be Government appointees, while administrative, technical and other support would be provided by the Ministry of Finance. The draft law envisages annual reporting to the Government only, thus limiting access by the public or the legislature.

122. As a whole, this approach fails to provide the commission with sufficient autonomy and protection from political influence. The Government should consider establishing the Commission for State Aid Control as an independent body reporting the Parliament, with professionals recruited through open, public competition. The role of the Commission could be strengthened by expanding the present definition of its responsibilities⁵⁵ and authorizing it to provide preliminary opinions on any legislative proposal or strategy concerning state aid, which would be binding prior to their adoption by the government.

ROADS

123. Spending on roads--including spending financed from tolls and earmarked tax revenues--accounted for about five percent of consolidated central government expenditure in 2008. In the immediate future, the Government confronts the need to

⁵⁴ EC Progress Report, 2008.

⁵⁵ These could include responsibility for: (i) the assessment of state aid proposals and aid schemes within annual and multi-annual state aid approval plans; (ii) monitoring the implementation and effects of state aid granted and order the recovery of unlawfully granted state aid; (iii) collection the data on the use and effects of state aid granted; (iv) cooperation with the authority responsible for state aid to agriculture and fisheries in the preparation of annual reports on state aid; (v) cooperation in the budget preparation process with the authorities responsible for the preparation of the state budget and the budgets of regional and local self-government units, in compliance with the separate law; and (vi) participation in the preparation of draft proposals for laws and other regulations concerning state aid, as well as promotion and encouragement of improvements in the state aid system.