Government of the Republic of Serbia

Pre-accession Economic Programme for 2013

January 2013

Important Disclaimer

This translation does not constitute an official translation and the Ministry of Finance and Economy cannot be held responsible for any inaccuracy or omission in the translation.

Contents:

I. Overall Economic Policy Framework and Main Objectives

The Republic of Serbia, as an EU candidate country, has drawn up its first Pre-accession Economic Programme (PEP) for 2013. In the context of national procedures, the PEP was prepared in cooperation with the National Bank of Serbia and the Republic's line ministries. The Government adopted the PEP on 24 January 2013 and submitted it to the European Commission on 31 January 2013. In the previous period, since 2006, as a potential EU candidate country, it was submitting to the EC the Economic and Fiscal Programmes.

The Overall Economic Policy Framework and Objectives covering the period 2013-2015 are based on strategic development documents of the Government, such as: the Stabilization and Association Agreement for the Republic of Serbia, the National EU Integration Programme of the Republic of Serbia, national development strategies – the overall and sectoral ones, the Fiscal Strategy covering the period 2013-2015. Economic policy for the forthcoming medium term has been designed in accordance with this strategic development framework. The entry into force of the SAA and the grant of the EU candidate country status have opened a new stage in the European integration process with prospects for the opening of the EU membership negotiations in 2013, geared to shaping and channelling development processes in the country on the basis of European standards and norms. The economic policy frameworks for the medium term are operationalized in keeping with the development objectives, directions and priorities as established by overall and sectoral development strategies aimed at accelerating growth and structural change in the Republic of Serbia's economy and society.

The strategic goal of economic policy which the Government will pursue in the coming period is the acceleration of the European integration process by conducting activities with a view to obtaining a date for opening the EU accession negotiations, and implementation of system-related reforms with a view to meeting the criteria set by the European Council in Copenhagen, through the stabilization and association process aimed at obtaining the status of a full-fledged EU Member State. To that effect, the adoption of all necessary system-related laws will be accelerated, and the implementation of the enacted laws and regulations ensured, geared to establishing a market economy, macroeconomic stability and the rule of law as well as curbing corruption and organized crime.

In late 2011, the European Commission made an assessment in its Opinion on the Republic of Serbia's bid for EU membership that the Republic of Serbia was making progress in the fulfilment of political and economic criteria, and honouring its obligations arising from the Stabilization and Association Agreement and the Interim Agreement, and recommended to the European Council to grant the EU candidate country status to the Republic of Serbia, taking into account the progress made thus far. The European Council granted the EU candidate country status to the Republic of Serbia on 1 March 2012.

The Government will step up the activities for obtaining a date for accession negotiations and continue to meet the Copenhagen criteria and obligations arising from the Stabilization and Association Agreement. In order to meet economic and political criteria for the EU membership, administrative capacity building and stability of institutions guaranteeing democracy, the rule of law, respect for human rights and minority protection, development of market economy, and building of its capacity to respond to EU competitive and market forces pressures will be ensured, as well as the creation of a stable economic and monetary environment.

In addition to the strategic development framework, which constitutes the starting platform for the formulation of economic policy for the medium term, more recent movements in international economic relations, achieved economic results in 2011 and 2012 and demonstrated development constraints have also been taken into account. In that respect, current economic developments will have significant implications for economic policy in the period from 2013 to

2015. The recovery of the global economy, in particular of leading European economies and recovery of the economy of the Republic of Serbia will crucially influence the profile of economic policy in 2013 and coming years. In improved conditions, acceleration of economic growth is expected, starting from 2013, and gradual return to higher growth rates from the pre-crisis period.

Development processes in the forthcoming mid-term period will be encouraged by more favourable impacts coming from the world economy, the anticipated pick up in foreign demand, enhanced economic activity and exports, the improved investment climate and business environment in the country, strengthening of market system mechanisms and improved competitiveness, maintenance of macroeconomic stability and investors' interest in investing in the Republic of Serbia, acceleration of reforms and European integration, establishment of public finance sustainability, strengthening of the regional development component, enhancement of the role of knowledge and innovation.

Concomitantly, the development processes will be constrained by the vulnerability of the economy following the economic and financial crisis, illiquidity of the real sector, inadequate credit support by banks to the real sector, rising costs of structural reforms, lack of investment capital for the development of the tradable goods sector, a volatile international environment and the debt crisis of certain countries in the euro area.

Economic policy, in addition to rising instability in international economic relations, will be also faced with inherited problems, first and foremost inflation, which is relatively high according to international standards, as well as with uncertain prospects for recovery of the real sector, high unemployment and a decline in wages, decelerated public sector reforms and a widening fiscal deficit and public debt. All these are potential threats and risks to macroeconomic stability and growth of the economy.

The global economic crisis, especially the recession and financial crisis in the euro area, have adversely affected the economy and public finances of the Republic of Serbia. Against such backdrop, economic policy was focused on creating conditions for macroeconomic and financial stability and economic recovery. In the period from 2013 to 2015 the plan is to accelerate economic activity and cut unemployment, which will largely depend on developments in the European economic environment and on the speed of the implementation of the structural reform plan and fiscal consolidation measures.

Acceleration of European integration and economic reforms envisaged by the SAA constitutes a significant impetus to the Serbian economy. A strong incentive to the economy will also come from the improved business environment which will attract investment, as well as from public sector reforms which include reform of the public administration and public services and efficient management of state-owned assets and public enterprises, and a reform of the social safety net. A new investment cycle supported by Government measures, and the completion of restructuring and privatization, are of special importance for the acceleration of the development process, in order to turn the private sector into the main driver of economic growth, and provide a new incentive for development to the Serbian capital market.

Bearing in mind incentives to and constraints on development processes in the forthcoming mid-term period economic policy will be oriented towards maintenance of macroeconomic stability and creation of conditions for sustainable economic growth. In that respect, the PEP for the period 2013-2015 looks at macroeconomic and fiscal developments and projections, and sets objectives and guidelines for economic and fiscal policies and structural reforms to be carried out in the coming three fiscal years. The focus of economic policy will be the implementation of the programme for boosting the economy, the fiscal consolidation programme, the public debt reduction programme and the structural reform plan.

Medium-term objectives of macroeconomic policy which the Government will pursue in the coming three fiscal years include: macroeconomic stability; economic recovery and growth acceleration; raising employment and living standards. The accomplishment of the objectives is planned primarily through boosting investment activity, implementing fiscal consolidation and accelerating reforms.

Macroeconomic stability is the key prerequisite for growth of the economy and for raising employment levels and living standards. The establishment of macroeconomic stability through the narrowing of macroeconomic imbalances (inflation, the fiscal deficit, the current account deficit) requires very close coordination between fiscal and monetary policies.

Economic recovery and acceleration of economic growth are becoming the main objective of economic policies. Economic growth in the coming three years will be moderate (3.2% per annum on average), due to a slower recovery of the global economy, particularly the European economies, a more subdued aggregate demand and decelerated labour market adjustment. Acceleration of economic growth is expected on the basis of fiscal adjustment and implementation of structural reforms which give rise to higher exports, savings, productivity and competitiveness, as well as a more favourable impact of the European economic environment.

Economic growth and improved competitiveness of the economy constitute a realistic basis for boosting employment and raising living standards. In the EU convergence process, it will be necessary to mitigate the Republic of Serbia's dramatic lagging behind in terms of the employment rate among the working age population as the main indicator of the situation on the national labour market, and that requires an average annual economic growth of the Republic of Serbia which is faster than the EU average, while at the same time increasing labour intensity of the growth. Acceleration in the growth of employment and improvement of living standards is expected as transition and restructuring of the economy progress, based on the elimination of institutional and structural constraints and more efficient pursuance of economic policies, after a sharp drop in employment and living standards in the period from 2009 to 2012. The year 2013 is expected to see the mitigation of the decline in employment and living standards, while from 2014 economic growth is expected to accelerate and employment and the standard of living are expected to go up.

II. Economic Developments and Medium-term Prospects

Economic developments and prospects of the Republic of Serbia in the coming mid-term period will be strongly influenced by the developments and prospects in the international economic environment, primarily in the euro area Member States as the Republic of Serbia's main partners in trade and investment.

According to the IMF's autumn projections, in 2012 the euro area and the EU 27 will be in a mild recession, -0.4% and -0.2% respectively. Germany, as the largest economy in the euro area, will grow by 0.9% in 2012, while Italy will post a GDP drop of 2.3%. Recession in the euro area diminishes economic prospects of Central and Eastern European countries, which, as a region, will post GDP growth of less than 2.0% in 2012 due to closer trade and financial links with the euro area countries. According to the estimates, recession in the euro area will be accompanied by a rise in the unemployment rate from 10.2% in 2011 to 11.2% in 2012.

Table 1. International Environment – Macroeconomic Indicators

	2011	2012	2013
Real growth of gross domestic product[1], %			
World total	3.8	3.3	3.6
European Union	1.6	-0.2	0.5
USA	1.8	2.2	2.1
Developing countries	6.2	5.3	5.6
Rise in world trade,%	5.8	3.2	4.5
Unemployment rate, %			
Euro area	10.2	11.2	11.5
USA	9.0	8.2	8.1
Consumer prices, annual change, %			
Developed economies	2.7	1.9	1.6
Developing countries	7.2	6.1	5.8
Oil price increases, in dollars, annual change, %	31.6	2.1	-1.0

[1] World GDP valued at purchasing power parity.
Source: IMF, World Economic Outlook, October 2012

The IMF estimated the EU real GDP growth for 2013 at 0.5% and the rise in the unemployment rate in the euro area to 11.5%. World trade growth is predicted to accelerate to 4.5%, while annual inflation is projected to fall to 1.6%. The IMF expects that global economic growth in the period from 2013 to 2015 will be accompanied by fiscal adjustment, improved conditions on the financial market and more favourable conditions on the labour market. Also anticipated are strong improvement in the budget balances, a gradual increase in banks' lending activity and private domestic demand, as the main drivers of economic growth.

In its autumn projections of macroeconomic indicators, the European Commission pointed to the stagnation in economic recovery of the EU countries with a major risk of going into a new recession. Unfavourable investment movements and a public debt crisis contagion risk resulted in downwards revisions of 2012 and 2013 economic activity growth projections for most of the countries. A gradual economic recovery in the coming period will be accompanied by necessary fiscal consolidation, improved conditions on the financial market, with unchanged conditions on the labour market and a possible rise in structural unemployment, which can undermine potential growth.

Table 2. The Republic of Serbia's Trade Partners - Main Economic Indicators

		2011	2012	2013	2014
Real GDP growth, in %	Italy	0.4	-2.3	-0.5	0.8
	Germany	3.0	0.8	0.8	2.0
	Euro area	1.4	-0.4	0.1	1.4
	Russia	4.3	3.7	3.9	4.0
Inflation, in %	Italy	2.9	3.3	2.0	1.7
	Germany	2.5	2.1	1.9	1.8
	Euro area	2.7	2.5	1.8	1.6
	Russia	8.4	7.7	7.4	7.4
Current account balance, % of GDP	Italy	-3.3	-1.2	-0.4	-0.3
	Germany	5.6	5.7	5.0	4.7
	Euro area	0.3	1.1	1.5	1.6
	Russia	5.4	3.6	3.2	2.9
Consolidated fiscal balance, % of GDP	Italy	-3.3	-1.2	-0.4	-0.3
	Germany	5.6	5.5	4.9	4.6
	Euro area	0.4	1.4	1.9	2.1
	Russia	1.3	0.3	0.2	-0.2
Gross government debt, % of GDP	Italy	120.7	126.5	127.6	126.5
	Germany	80.5	81.7	80.8	78.4
	Euro area	88.1	92.9	94.5	94.3
	Russia	12.1	11.5	10.9	10.4
Unemployment rate, in %	Italy	8.4	10.6	11.5	11.8
	Germany	5.9	5.5	5.6	5.5
	Euro area	10.1	11.3	11.8	11.7
	Russia	6.6	6.4	6.2	6.1

Source: European Economic Forecast- Autumn 2012

The risks associated with the materialization of the above projections are predominantly related to the fiscal sustainability and stability of the European currency due to rising government debt in certain countries, as well as the high unemployment rate prevailing in a fair number of the Member States. Securing fiscal sustainability remains the greatest challenge for the EU. Contraction of world trade caused by deceleration of economic growth would also adversely affect global demand and net exports and, consequently, economic growth.

1. Macroeconomic Developments in 2011 and 2012

The PEP presents in this section current economic developments on the basis of main economic indicators for 2011 and 2012, such as GDP, industry and other sectors, consumption and investment, the external sector, employment, productivity, wages, inflation, monetary and credit variables, the exchange rate.

The economy of the Republic of Serbia in 2011 slightly recovered and posted real GDP growth of 1.6%. In 2012, the economy weakened, which is demonstrated by the posted drop in real GDP in the first (-2.3%), second (-0.6%) and third (-2.5%) quarter of 2012. The recovery turned out to be fragile and the economy went through another phase of contraction due to slackening external demand and consequential deceleration of exports, and due to poor weather conditions in the country. Key sectors in 2011 mildly grew, while in 2012 they were falling, affected by the deceleration of the economies of the EU and the region, and by the adverse weather conditions in the winter and summer periods.

Exports and imports of goods and services in euro terms recorded moderate growth rates in 2011 (13.9% and 13.6%), while estimates for 2012 suggest low growth rates for exports and imports of goods and services in euro terms (2.9% and 3.6%). The current account deficit widened to 8.9%

of GDP in 2011 from 6.6% and 6.7% of GDP in the previous two years. The year 2011 saw strong inflows of net foreign investment, while in 2012 investment inflows sharply declined.

Labour market indicators were negative in both 2011 and 2012, as were in the preceding two years. The total number of registered employed persons sharply declined, predominantly in the private sector, while the unemployment rate soared to 23.7% in November 2011, to decline to 22.4% in October 2012.

Actual inflation in 2011 and 2012 stood at 7% and 12.2%, respectively, and was higher than the NBS inflation target set at 4.5% and 4.0%, respectively, without envisaged tolerance bands of ± 1.5% percentage points. The inflation target was exceeded by a wide margin, especially in 2012. A dominant influence on inflation in 2011 and 2012 was exerted by the food prices.

Fiscal performance deteriorated in 2011 and 2012. The fiscal deficit in 2011 stood at 5.0% of GDP, and in 2012 at 6.1%. Public debt went significantly up in 2012, due to the rising fiscal deficit and dinar depreciation. The public debt-to-GDP ratio at end-2011 was 50.2%, and the estimate is that it will stand at around 65% of GDP at end-2012. A sudden surge in public debt over the previous years gave rise to an increase in interest payment on debt servicing to 1.4% of GDP in 2011, and to 1.5% of GDP in 2012.

Economic indicators for 2011 show that the recovery of the economy came to a standstill in mid- 2011 due to negative effects of the double dip of the global economic crisis, and the weakening of growth and financial problems in the euro area. Against the backdrop of exacerbated economic circumstances in 2011 real GDP growth was 1.6%, based on growth of industrial and agricultural production, the construction industry, transport and telecommunications on the production side, while on the expenditure side on investment growth. The largest positive contribution to the rise in gross value added of activities comes from the sector of information and communications (1.1 percentage points) and the sector of industry (0.5 percentage points), while the largest negative contribution was made by wholesale and retail trade sectors (-1.2 percentage points).

In the field of foreign trade in 2011, exports of goods went up in euro terms by 14.2%, while imports goods in euro terms were higher by 12.9%. However, estimated faster real growth in imports of goods and services (6.8%), compared to the growth in exports of goods and services (3.6%), resulted in negative contribution of net external demand to GDP growth (2.6 percentage points). The deficit in the overall trade balance amounted to 16.6% of GDP, and the current account deficit to 8.9% of GDP. Coverage of imports of goods and services by exports of goods and services was 69.0%. Regarding exports, the products exported the most included food, base metals and chemicals, while in the case of imports those were means and equipment for reproduction as a result of realized investments in export oriented industries. The most important exports markets were Germany, Italy and Bosnia and Herzegovina. At end-2011 exports of goods were by 13.6% higher than their pre-crisis level, while goods imports were 13.5% lower than their pre-crisis level (2008).

The current account deficit in the balance of payments in 2011 was financed by higher inflows of portfolio investment (EUR 1.6 billion) as a consequence of a stronger interest on the part of foreign investors for investing in long-term Treasury bills of the Republic of Serbia, owing to the favourable interest rate differential and a decline in the country risk premium, stronger inflows of foreign direct investment (EUR 1.8 billion) and government long-term borrowing. The increased net capital inflows contributed to the rise in foreign exchange reserves and stabilization of movements on the foreign exchange market.

On the labour market, a drop in employment was recorded in 2011, as well as a rise in the unemployment rate and a slight increase in real terms of the average net wages. A mild economic recovery was not sufficient for reversing negative trends on the labour market. The total number of employed persons amounted to 1,746 thousand and was reduced by 2.8%. According to the Labour Force Survey of November 2011, the unemployment rate was 23.7%. The rate of formal employment stood at 35.3%, the rate of informal employment was 17.8% while the rate of long-term unemployment was 17.6%. A real rise in average net wages amounted to 0.2%. The average net wage in euro terms amounted to EUR 372.

Inflation in 2011 was 7%. Current growth in consumer prices in the first semester of the year was 6.9%, and in the second 0.3%. The main generator of inflation in the first semester of the year was a surge in food prices caused by a bad agricultural season in 2010 and increases in the primary agricultural produce prices. Instability of food prices is a consequence of an underdeveloped market, poor system-related arrangements and unpredictable economic policy measures, as well as of a high share of food in the consumer price index. Increases in the prices of electricity, cigarettes, medicines and petroleum products also contributed to an upsurge in headline inflation. In the second semester of the year food prices had a disinflationary effect owing to the abating of cost pressures on price hikes with a new agricultural season, as well as low aggregate demand and undertaken monetary policy measures. Deceleration of year-on-year and monthly inflation rates as of May resulted in the convergence of inflation to the ceiling of the inflation target range (4.5 ±1.5%) at end-2011.

In 2011, M1 recorded a year-on-year increase of 16%. Total deposits with commercial banks went up by 8.9%. Foreign exchange deposits were increased by 6.6%, while savings and time deposits rose by 23.5%. Total commercial bank credit at end-2011 recorded a year-on-year increase of 6.8%. Year-on-year enterprise credit growth amounted to 8.3%, and growth of credit to households was 5.3%. The share of non-performing loans in total approved loans as at 31 December 2011 was 19%. Capital adequacy of the banking sector at end-2011 stood at 19.11%.

The average nominal exchange rate of the dinar against the euro in 2011 was EUR/RSD 101.95 and in comparison with the previous year, it appreciated by 1.1%, while the real effective exchange rate appreciated by 4.4%. The NBS intervened on the inter-bank foreign exchange market in 2011 by selling EUR 90 million and buying EUR 45 million.

Economic indicators for 2012 suggest a decline in economic activity, deceleration of growth in exports and imports of goods, widening of balance of payments and fiscal imbalances, a surge in inflation, a decline in employment, a rise in unemployment, real wage growth, more restrictive monetary policy, weakening of the dinar, reduction of foreign exchange reserves, deceleration in lending activity of banks and a high share of non-performing loans in total approved loans.

The year 2012 was marked by a decline in economic activity and high inflation. Poor weather conditions in the winter and summer seasons, as well as recession in the euro area and deceleration of growth in the main foreign trade partners of the Republic of Serbia, had an adverse effect on industrial and agricultural production and on exports. Hikes in food prices on the local and world markets and fiscal expansion in the run-up to the elections generated inflation.

Recessionary tendencies in the economy of the Republic of Serbia are to a large extent a consequence of the slowdown in economic and external economic activity in the euro area and in countries of the region, as the most important partners of the Republic of Serbia in the fields of trade and investment. A declining trend in industrial production, particularly in manufacturing industry, as well as decelerated growth in exports and imports are partly caused by the adverse weather conditions. Low temperatures in the first two months of the first quarter led to the standstills in production, problems in traffic and power cuts in parts of the economy. A fall in manufacturing industry was also aggravated by the departure of the private owner of the U.S. Steel from the domestic market. On top of that, the long drought in the summer months unfavourably impacted the yield of autumn field crops, fruit and vegetables and caused a steep fall in agricultural production.

Industrial production in the period January-November 2012 recorded a year-on-year decline in physical volume by 3.3%. A fall in the manufacturing industry in this period (-2.3%) made the largest contribution to the decline in industrial production. Turnover in retail trade over the period January-November 2012 recorded a real year-on-year fall of 5.2%, and the number of tourist nights went down by 2.8%. In the first nine months of 2012, building activity, measured by the value of performed works, went up in real terms by 3.7%, the physical volume of transport went up by 0.1%, and the volume of telecommunications services by 17.2%.

The balance of payments position of the Republic of Serbia in 2012 deteriorated, with the recession in the EU and the region with which the Republic of Serbia has thriving trade and investment. Exports and imports of goods in the period January-November 2012 rose at low rates, 4.4% and 4.2%, respectively, with a trade deficit of EUR 5.3 billion. The current account deficit in the first ten months widened by 24.3% relative to the same period of 2011 and amounted to EUR 2.7 billion. Such development was a result of a year-on-year increase of the deficit in the trade of goods balance by EUR 351.8 million, a mild increase of the surplus in the services balance, a rise in the deficit in the income balance by EUR 71.7 million, and a decrease of the surplus in the current transfer balance of EUR 102.1 million. In the period January-October, coverage of imports of goods and services by exports of goods and services amounted to 68.9% and was reduced by 1 percentage point against 2011.

The low inflows of net foreign direct and portfolio investment in 2012 resulted in a strong depreciation of the dinar in the first part of the year and to an increase in the external debt levels. Political uncertainty surrounding the general elections and the formation of the new Government, reduced net foreign exchange earnings, the rising fiscal deficit and the hike in inflation contributed to the weakening of the dinar. The NBS heavily intervened in the first semester of 2012 and supported the dinar in its fall; nevertheless, it maintained foreign exchange reserves at a satisfactory level, covering the value of about 7 months of imports. Foreign financing risks were mitigated by available foreign exchange reserves and a favourable structure of external debt, dominated by the long-term portion of it.

The situation on the labour market in 2012 was adverse, as was in the previous years of transition from 2001, and since the economic crisis of 2009. According to the October 2012 LFS, the unemployment rate stood at 22.4%, and the employment rate at 36.7%, which was more favourable than in November 2011, when the unemployment rate was 23.7%, and the rate of employment 35.3%. Economic growth and investment of 2008 were not sufficient to create new jobs and cut unemployment. Employment declined in the private sector, while in the public sector the number of the employed remained unchanged. The creation of sustainable employment constitutes a major challenge to economic policy in the coming period.

Inflation reached 12.2% at end-2012, which is a high rate in a recessionary setting. Inflation was driven by food price increases and a rise in regulated prices. The raising of the standard VAT rate and deferred effects of dinar depreciation from the first half of the year also contributed to inflation. Sluggish aggregate demand had a disinflationary effect, as did fiscal consolidation embarked upon in the fourth quarter of 2012.

After a cut in January 2012, the reference interest rate was not changed until June. After June, the NBS responded to the expected strengthening of inflationary pressures by gradually raising the reference rate. As a result, by the end of 2012 the reference interest rate was increased by 1.75 percentage points to reach the level of 11.25%. The decisions on the raising of the reference rate were passed primarily with a view to preventing the pass-through from agricultural produce price growth caused by the long-lasting drought and increases in world food prices, as well as from the raising of the VAT rate to other prices through inflationary expectations, and thus contributing to macroeconomic stability.

In the course of 2012, the NBS Executive Board changed the Decision on the Required Reserves of Banks with the National Bank of Serbia several times. In April, the ratios of the reserve requirement on foreign exchange were cut, with the cut being deeper for sources of funding with longer maturities (on sources of up to two years to 29%, and on sources of more than two years to 22%). The ratios on foreign currency indexed deposits were increased in June to 50%, and this segment of the foreign exchange base declined after that. The share of the dinar portion of the set aside foreign exchange reserve requirement was increased twice during the year, from 20% to 32%

on sources whose maturity is up to two years, and from 15% to 24% on sources with maturities longer than two years. The aim of the changes was to contribute to the stabilization of movements on the foreign exchange market, to reduce the difference between the cost of borrowing in dinars and in foreign exchange, as well as to further encourage long-term bank financing.

During 2012, the value of the dinar against the euro fell in nominal terms by 8.0% (in real terms, the dinar strengthened by about 1%). Depreciation pressures, which started in late-2011, went on in the first five months of 2012 as well. Over that period, the dinar lost 9.0% of its nominal value against the euro, which is mostly a consequence of higher public spending, a high trade deficit and low capital inflows caused by uncertainty in the country with respect to structural reforms and fiscal policy, as well as abroad, due to the sovereign debt crisis in the euro area. The steady weakening of the dinar was stopped in June, mostly owing to restrictive monetary policy measures and a programme of subsidized loans for enterprises from September, since they were predominantly financed out of foreign currency denominated sources and paid in dinars. As of early September, a stronger interest among foreign investors for investing in the Republic of Serbia could be observed, sparked by both higher liquidity on the international money market, and a clearly demonstrated intention of the Government to implement fiscal consolidation. These factors led to appreciation of the dinar of around 4% in the period from September to the end of 2012.

In 2012, the NBS intervened on the inter-bank foreign exchange market by selling EUR 1,348.3 million and buying EUR 5.0 million in order to ensure smooth operation of the foreign exchange market and mitigate excessive daily volatility of the dinar exchange rate. The largest portion of that amount is related to the first half of the year, while in the second semester of the year interventions were sporadic, aimed at mitigating excessive daily fluctuations of the dinar exchange rate.

Over the period January-November 2012, M1 recorded a year-on-year increase of 5.3%. Total deposits held with commercial banks went up by 10.6%. Foreign exchange denominated deposits were increased by 14.7%, while savings and time deposits declined by 3.8%. Total commercial bank credit recorded a year-on-year growth of 12.2%. Year-on-year growth in enterprise credit was 13.7%, and of credit to households 8.4%. The share of non-performing loans in total approved loans at end-September 2012 amounted to 19.9%. Banking sector capital adequacy at end-September 2012 amounted to 16.4%.

Fiscal performance in 2012 deteriorated. Fiscal imbalance was increased to 6.1 % of GDP, while the targeted fiscal deficit for 2012 was 4.25% of GDP. The higher fiscal deficit is a consequence of a decline in economic activity and lower public revenue, as well as of intensified spending in the run-up to the elections. The debt of the central level of government continued to rapidly grow in 2012 as well, due to the widening fiscal deficit and dinar depreciation, and at end-November it amounted to EUR 17.56 billion. The deterioration of fiscal performance contributed to the lowering of the long-term credit rating of the Republic of Serbia in August.

2. Macroeconomic Scenario for the Medium Term

The PEP presents in this section the macroeconomic scenario for the medium term from 2013 to 2015, as well as economic policies which support the predicted macroeconomic developments.

On the basis of current economic movements in Serbia and the international environment, and downgraded estimates of macroeconomic indicators by international financial institutions, the main macroeconomic aggregates and indicators for the Republic of Serbia over the medium term have been projected. Estimates of GDP and related indicators were revised downwards, primarily due to recession in the euro area and the resulting decline in domestic exports and inflows of foreign capital, as well as a fall in agricultural production caused by the harsh weather.

Macroeconomic projections covering the period from 2013 to 2015 indicate a possible GDP growth in 2013 of 2.0%, followed by the acceleration of growth to 3.5% and 4.0% in 2014 and 2015, respectively. The projected average growth rate for the coming three years of 3.2% will enable a rise in employment in 2014 and 2015, accompanied by productivity growth which would improve international competitiveness of the economy. The change in the economic structure towards faster growth of exports than imports of goods and services, and incentives to investment activity, will be continued in the coming period. Acceleration of growth in exports and investment is the underlying development factor which will, together with restructuring of the economy towards tradable goods, enable acceleration of growth and the narrowing of internal and external macroeconomic imbalances.

The predicted cumulative GDP growth of 9.8% in the coming three years is based on the stepping up of growth in investment and exports of goods and services at an average annual real rate of 8.2% and 10.3%, respectively, with a mild average annual rise in private consumption (0.2%) and cuts in government spending (-0.6%). On those bases, an increase in employment and productivity will be secured, as well as a change in the economic structure towards a rise in the share of industry in GDP.

The medium-term macroeconomic projection suggests a slight increase at end-2015 in the share of fixed capital formation to around 17% of GDP, a cut in the government spending-to-GDP ratio to 20.2% and a rise in the share of exports of goods and services in GDP to 48%. Furthermore, in the coming three years the share of domestic savings in GDP is predicted to grow owing to the rise in private savings. Net inflows of foreign direct and portfolio investment of around EUR 2.3 billion a year on average are needed, with a change in their structure towards the tradable goods sector. Balance of payments financing implies a simultaneous cut in the share of the deficit in trade of goods and services and the current account deficit (including grants) in GDP to 12.8% and 7.0%, respectively, at end-2015, in order to ensure the narrowing of the absorption gap, the sustainability of external debt, external liquidity and solvency.

Table 3. Projection of Main Macroeconomic Indicators for the Republic of Serbia

	Estimate	PROJECTION			
	2011	**2012**	**2013**	**2014**	**2015**
GDP, millions of dinars (current prices)	3,175,024	3,267,099	3,679,015	3,979,131	4,316,243
GDP *per capita*, in euros	4,288.3	3,966.7	4,295.5	4,545.3	4,846.8
GDP, real growth, %	1.6	-2.0	2.0	3.5	4.0
Real growth of individual GDP components, %					
Private consumption	-0.7	-0.7	-1.3	0.7	1.0
Government consumption	-1.4	4.8	-4.4	0.8	1.7
Investment	26.9	-14.5	8.7	7.5	8.4
Exports of goods and services	3.6	1.8	9.2	10.6	11.1
Imports of goods and services	6.8	-0.4	2.5	5.5	6.6
Balance of goods and services trade, in euros, % of GDP	-16.6	-18.9	-16.2	-14.4	-12.8
The number of the formally employed, annual average, in 000	1,746.1	1,725.0	1,721.6	1,742.2	1,782.3
Investment ratio, % of GDP	17.1	14.6	15.2	16.0	16.8
External debt, % of GDP, end of period	77.5	87.7	87.5	85.4	85.2

Source: MFE

Real Sector

The PEP in this section provides the necessary information on medium-term prospects for the real sector, which enables an analysis of the economy's cyclical stance. It looks at expected sources of real GDP growth in terms of changes in factors of production and aggregate demand.

Deceleration of global economic growth, recession in the euro area and at the EU level, a rise in the risk premium and the Republic of Serbia's deteriorated credit rating, expansive fiscal policy in the first half of 2012 and very severe weather conditions in the winter and summer seasons in the region and in the Republic of Serbia, adversely affected macroeconomic indicators for 2012. In the period January-September 2012, economic activity fell year-on-year by 1.8% in real terms. Taking into account the above factors, GDP is estimated to fall in 2012 by 2% in real terms. A year-on-year decline in GDP is also expected in the fourth quarter of 2012, after the fall in real terms in the first (-2.3%), second (-0.6%) and third (-2.5%) quarter. At the level of sectors, the most massive fall in 2012 will happen in agriculture by about 20%, due to the bad agricultural season with a negative contribution of 2.1 percentage points, as well as in industry of 3.6%, with a negative contribution of 0.7 percentage points. The service sector will positively impact on GDP with 0.8 percentage points, while the construction industry will make a zero contribution to GDP.

Graph 1. Real GDP Growth: Actual Rate and Long-term Trend, in %

On the expenditure side of GDP, the rise in government spending and net exports in 2012 will make positive contributions to GDP (0.9 and 1 percentage points, respectively), while private and investment consumption will decline. The perennial fall in real terms of private consumption continued in 2012, too, as a consequence of falling real household disposable income, predominantly as a result of extremely negative developments on the labour market. According to the estimates, investment spending in 2012 will fall in real terms, after its growth in 2011, negatively contributing to economic activity with 3.3 percentage points. The reason for that is considerable slackening of domestic and foreign demand, high illiquidity of the domestic economy and tightened financing conditions. Net exports are expected to make a positive contribution to GDP growth in 2012, of 1 percentage point. The expected positive contribution of net exports is related to exports of cars and components and effects of dinar depreciation in the first semester of the year. On the other hand, Serbian exports were adversely affected by the low yield of agricultural produce and poor global market conditions. As a consequence of sluggish demand, imports of goods and services are estimated to decline in real terms, while the export growth trend, which started in the third quarter of 2012, will be continued in the fourth quarter, owing primarily to the kick-start of the production and exports of the automotive industry.

In 2013, real GDP growth is estimated at 2%. On the expenditure side, net exports are expected to be the main driver of growth, bearing in mind that full effects of the launch of production and exports of *Fiat-automobili* will be felt in 2013. Private consumption is expected to decline in real terms, as a result of a drop in real household disposable income, a slight decline in employment and an estimated real drop in net wages. On the production side, a mild recovery of industrial production and an average agricultural season are expected to contribute to GDP growth with 1.8 percentage points.

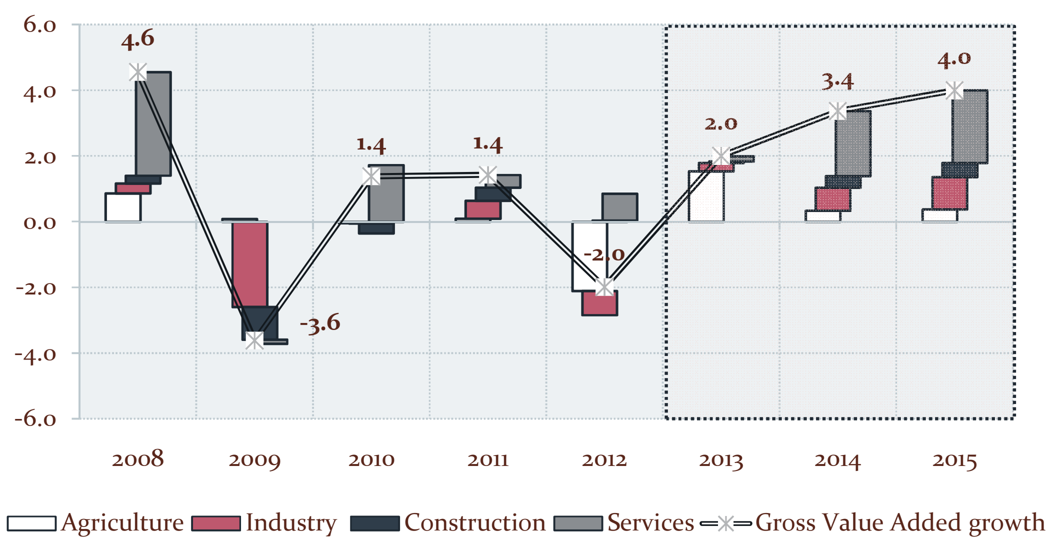
For the forthcoming three year period, real GDP is predicted to grow at an average annual rate of 3.2%. For 2013, real GDP growth of 2% is anticipated. The implementation of the fiscal consolidation measures and enhancement of the business and investment environments will enable the formation of a basis for stable and sustainable growth in the coming years. Fiscal consolidation will not significantly contribute to the deceleration of growth in economic activity in 2013, while its effects on economic growth in the medium and long term will be substantial.

Acceleration of GDP growth in 2014 and 2015 to 3.5% and 4.0%, respectively, is based on an increase in net exports and on a gradual recovery of consumption and investment activity.

On the production side of GDP, in the period 2013-2015, the stepping up of activity is expected in most of the sectors of the economy. Economic policies will focus on boosting industrial and agricultural production and exports, primarily through providing incentives to major investments in sectors which provide tradable goods, and by encouraging faster development of small and medium-sized enterprises. Sustainable growth of the economy implies the launching of stronger development of agriculture and industry, in particular the export-oriented branches, thus providing a realistic basis for economic development.

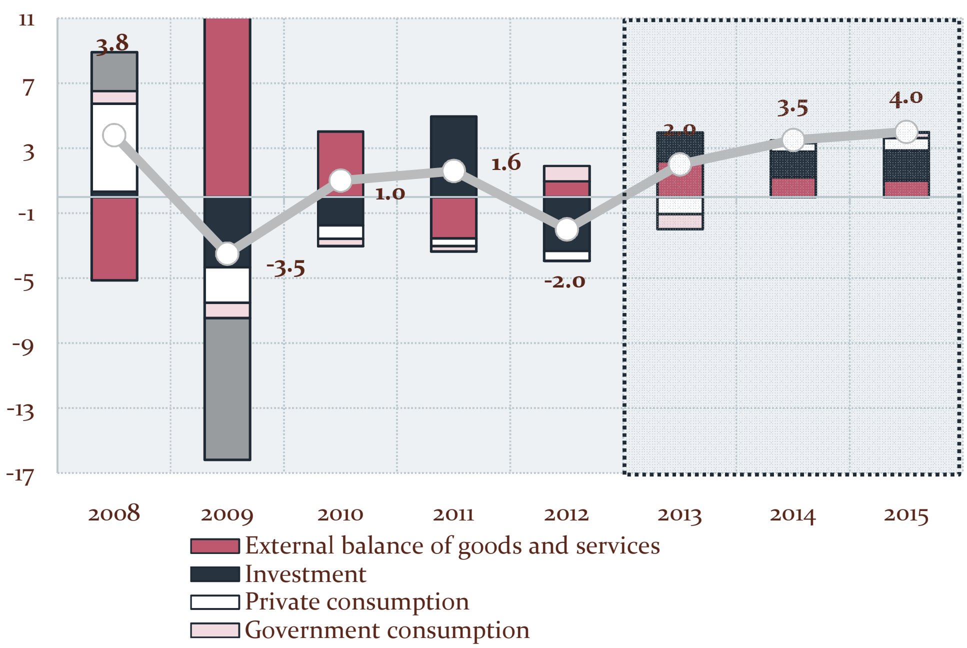
On the expenditure side of GDP, in the period 2013-2015, the largest contribution to growth is expected to come from net exports with 1.5 percentage points a year on average, while investment spending with average annual real growth of 8.2% is expected to make its contribution to GDP growth with 1.7 percentage points per year on average. The rise in private consumption, after the initial fall in 2013, will be limited by modest real wage bill growth, while government spending will give a negative contribution to GDP. Real government spending growth in 2014 and 2015 relies on, besides the low base of 2013, the re-application of the statutory fiscal rules on the indexation of pensions and wages in the general government. A stronger recovery of domestic demand is expected in 2014 and 2015. Acceleration of GDP growth in the coming years is based on the recovery of investment activity and on the effects of fiscal consolidation. Fiscal consolidation measures envisage cuts in public expenditure and a moderate increase in tax revenue, while changing their structure, which will also imply a change in the structure of aggregate demand. Planned cuts in public expenditure for purchases of goods and services, restrictions on the growth of pensions and wages of employees in the general government and the raising of the tax burden, will contribute to a fall in aggregate demand in 2013, while the planned increase in public investment will have an effect on aggregate demand growth. Fiscal consolidation will have indirect effects on boosting aggregate demand through increases in private investment demand and higher net exports.

Graph 2. Sector Contributions to Growth in GVA by Activity, p.p.



The macroeconomic projection indicates real growth in fixed capital formation of 8.7% in 2013 and 7.5% and 8.4% in 2014 and 2015, respectively, which will be generated by launching the new investment cycle of public enterprises, while private sector investment will follow later. In 2013, real growth in exports of goods and services of 9.2% is expected, and a slower rise in imports of goods and services of 2.5%; hence net exports will constitute the main source of GDP growth with a contribution of 2.3 percentage points. Strong export growth will continue in 2014 and 2015 as well. The projected increase in imports in 2014 and 2015 refers to imports generated by investment growth, i.e. to capital goods imports.

Graph 3. Contributions of Aggregate Demand Categories to Real GDP Growth, p.p.



The predicted development scenario indicates limited possibilities for increasing private consumption and government spending. A slower increase in private consumption and government spending relative to investment, as well as a faster growth in exports relative to imports, are key factors for achieving macroeconomic stability and sustainable economic growth. Moreover, investment growth is of crucial importance, bearing in mind that the decline in economic activity over the previous, pre-crisis period, resulted in a reduction of potential GDP through a loss of economic capacities and deterioration of conditions on the labour market.

In the materialization of the projection there is a risk of consumption growth beyond planned levels, which would lead to a surge in inflation and depreciation of the dinar, as well as to a decline in foreign exchange reserves, compounded by external debt servicing problems. On the other hand, investment spending of the private sector is expected to make a larger contribution to GDP growth. Weak inflows of foreign capital constitute the biggest risk for the pace of investment activity in the coming period.

The main rule of efficiency and growth through higher productivity is to first utilize the existing capacities of the economy for the purpose of producing a higher quality and quantity of goods. The output gap which measures the cyclical nature of economic activity was negative during the period of transition with the exception of 2007 and 2008 (1.8% and 1.6%, respectively) driven first and foremost by strong domestic demand. A rise in the output gap in 2007 (by almost 3 percentage points of potential GDP) and a high positive output gap in 2008 strongly indicate that the economy was overheated (a high rise in credit activity and real wage growth, as well as a wide trade deficit and a current account deficit), and that economic growth from this period was not sustainable in the long run. In 2009, due to the economic activity fall, the negative output gap widened, and this continued in coming years as well. Deceleration in the growth of productive potential of the economy is a consequence primarily of lower investment in production capacities, difficulties in financing current production activities of companies and negative trends on the labour market.

The projection of potential growth covering the period 2013-2015 is based on a gradual economic recovery, with the expectations that the output gap will be positive in 2015, after six years of the negative ratio between actual and potential GDP growth rate.

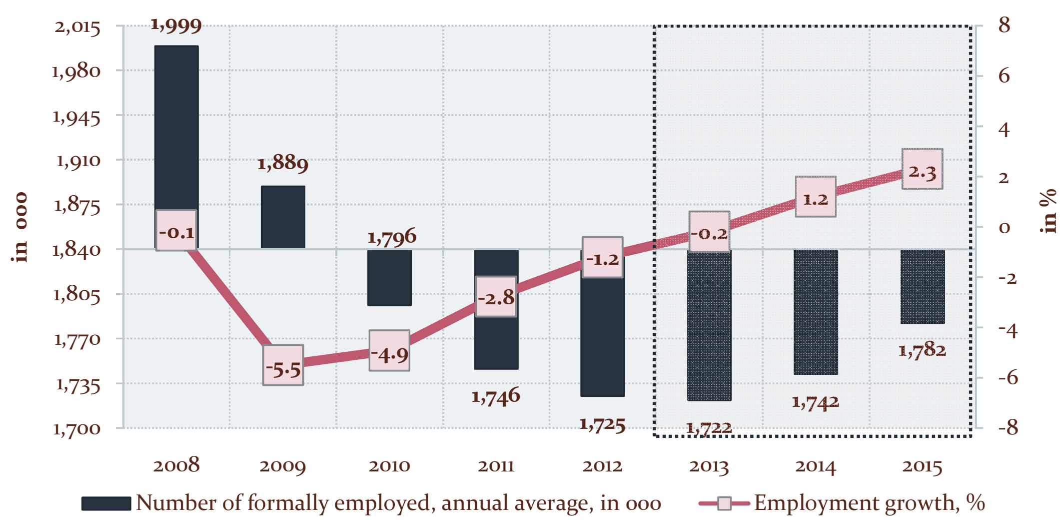
According to the estimates, growth in potential GDP over coming years will be positively influenced by the intensification of investment activity and, to a smaller extent, a rise in the participation rate. The unemployment rate is expected to decline as of 2014. Similarly, fixed capital formation is estimated to make the largest contribution to the potential growth rate in the coming period, while the contribution of labour to the potential GDP growth rate will be positive in 2014 and 2015.

Bearing in mind the current cyclical stance of the Republic of Serbia and structural disruptions inherited from the previous period, as well as the degree of the existing untapped capacities, it will be especially important to find the ways to increase total factor productivity, which fell in the previous period, primarily as a result of a decline in investment efficiency. To that end, it is necessary to carry out structural reforms which will secure long-term and sustainable development of the country, based on higher productivity of the economy.

Employment and Wages

The medium-term employment projection is based on the projected growth of GDP and investment. According to the projections, the drop in total employment will decelerate in 2013, after sharply falling in the past four years. Registered employment is expected to cumulatively grow by 3.3% in the coming three years. At the same time, total unemployment will record a slight decrease. Of special importance to productive employment in the coming period is the alignment of employment, education and scientific-technological development policies, with a view to raising the level of knowledge and skills and employment in line with the labour market needs.

Graph 4. Projection of Employment



The expectation is that the increase in real wages in the forthcoming period will be accompanied by the rise in labour productivity in the economy. A slower pace of real net wage growth than that of real GDP growth, as well as increases in gross wages aligned with productivity growth, will contribute to cuts in unit labour costs, and to the improvement of the country's competitive position.

Monetary Policy, Exchange Rate Policy and Inflation

The PEP presents in this section the intended monetary policy and its relationship with price stability, the exchange rate regime and financial system stability. Similarly, it presents the expected inflation path in 2013 and coming two years, and risks associated with the inflation projection, as well as policy instruments for meeting the inflation target.

The Monetary Policy and Exchange Rate Regime

Inflation targeting has been a monetary strategy of the National Bank of Serbia (NBS) since 2009, although gradual introduction of this scheme's elements into practice started as early as 2006. The main goal of the NBS monetary policy is to reach the inflation target in the medium term, which will help to maintain the stability of the financial system and achieve sustainable economic growth.

The NBS inflation target is defined as an overall inflation rate (including the tolerance band) as measured by annual percentage change in the consumer price index. Inflation targets are set in collaboration with the Government, based on the analysis of the current and projected macroeconomic movements and the adjustment mechanism applicable to the prices of goods and services that the Government can influence either directly or indirectly. Based on these considerations, the inflation targets for 2013 and 2014 are fixed at the level of 4% for all months, with the tolerance band of ±1.5 percentage points.

The NBS will use all the available monetary policy tools to ensure that the inflation target is achieved and that the deviations from the inflation target are temporary. Temporary deviation from the inflation target is allowed when, in order to scale inflation back to the targeted tolerance band in a short time, the monetary policy needs to change in such a way that it could cause additional macroeconomic instability. This applies in particular to cases of abrupt and unexpected change in the commodity prices but also to deviations from the planned growth of goods prices that are directly or indirectly influenced by the Government's decisions and to cases of one-off price increases due to change in tax policy. In an effort to achieve the inflation target, the NBS uses the primary monetary policy tool - interest rate applicable to main open market operations. The level of this interest rate changes in a consistent and foreseeable manner, depending on economic trends and inflation projections. Other monetary policy tools, such as open market operations in long-term securities, reserve requirements and interventions in the foreign exchange market, play an ancillary role in achieving inflation targets. They should contribute to smooth pass-through of the effects of the reference rate change to inflation and economic activity, and to the development of financial markets, without distorting the stability of the financial system.

The NBS will continue to apply the managed floating exchange rate regime. The NBS intervenes in the foreign exchange market in order to reduce excessive daily fluctuations in the exchange rate and/or to stimulate trade in order to ensure smooth operation of the foreign exchange market and to maintain financial system stability. The NBS will continue to develop and strengthen market-related instruments of monetary regulation and, in cooperation with the banks, to provide conditions for further enhancement of interbank money market.

Inflation

The beginning of 2012 was marked by scaling year-on-year inflation back to the targeted inflation tolerance band, after which the inflation rate continued to fall until April 2012, when year-on-year inflation was slightly below the floor of the tolerance band. The declining inflationary trend turned around in May 2012 with the arrival of a new agriculture season, after which inflation continued to rise. Higher food prices caused by the poor agriculture season due to the long-lasting drought, weakening of the dinar in the first half of the year and higher VAT and excise duties caused year-on-year inflation to go up in the second half of the year to reach 12.2% in December (year-end target was 4±1.5%).

The medium-term inflation projection is based on the planned fiscal consolidation, more stable food prices, a controlled increase of regulated prices, a lower risk premium, higher capital inflows and a stable exchange rate, lower inflationary expectations and a better global economic outlook. A significant drop in the inflation rate in the next three years will be secured on these grounds.

The decline in the inflation rate is expected to start in the second quarter of 2013, and its return to the inflation target tolerance band, by the end of that year. In addition to the NBS's restrictive measures, this will be achieved through the expected decline in food prices with the arrival of a new agriculture season, low aggregate demand and fiscal consolidation measures. In the absence of major shocks, inflation in 2014 should remain within the tolerance band.

Table 4. Inflation Projection, %

	2013	2014	2015
Inflation, end of period	5.5	5.0	4.5
Inflation, average for the period	11.1	4.8	4.5

Source: Ministry of Finance and Economy

Key risks to achieving the projected inflation rate include the heightened cost pressure on food prices; faster-than-expected growth of regulated prices and import prices; widening of the fiscal deficit beyond the planned level; a possibly higher risk premium, depreciation pressures and inflationary expectations; and slow and long-lasting recovery of the global economy.

External Sector and Its Viability in the Medium Term

This section of the PEP gives an overview of the expected current account movements and current account medium-term viability. The country's external position in the medium term is assessed based on the balance of payments exposure to external imbalances, relying on the analysis of movements in the net international investment position; price and cost competitiveness by applying the real effective exchange rate; and nominal unit labour costs.

Projections and Viability of the Balance of Payments

Balance of payments data show that the trade-in-goods movements and the balance-of-payment position of the country worsened in 2012.

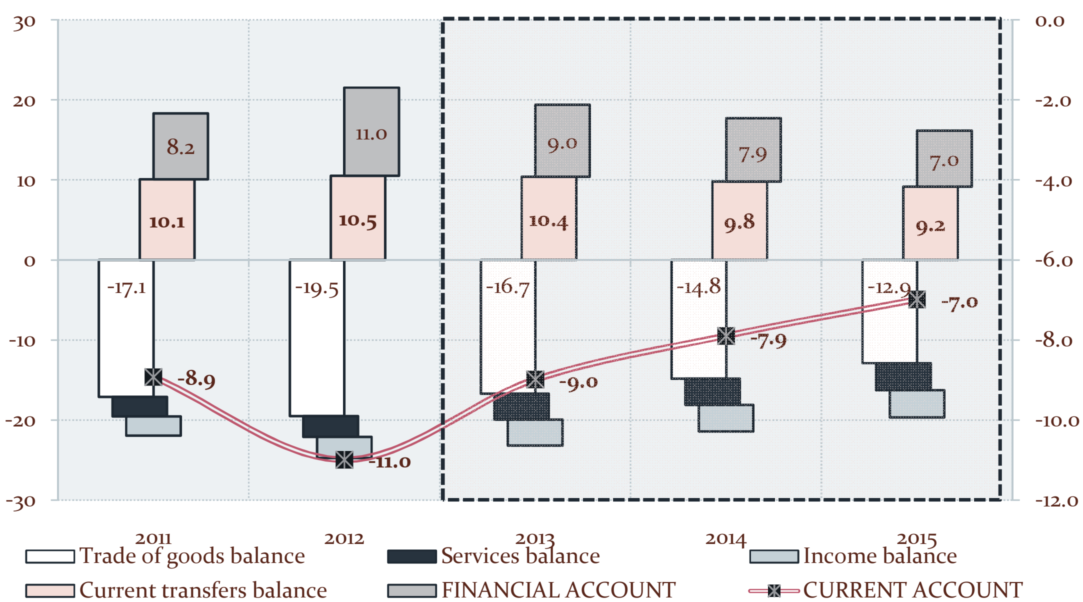
Essential for the viable balance of payments is to increase exports and net foreign capital inflows. The macroeconomic projection envisages higher exports and higher inflows of foreign investment in 2013 and the coming two years, with a view to reaching pre-crisis growth rates. A precondition for significant growth in exports is the implementation of structural reforms, along with improving cost and price competitiveness. This would increase a share of the Serbian exports in the global market. Trade in services could boost the current account balance, in addition to trade in goods.

The medium-term and long-term viability of the current account balance will depend on the implementation of structural reforms and improved competitiveness of goods and services exports. The viability of the balance-of-payments position requires moderate growth of interest expenses, as these would exert strong pressure on the current account deficit to grow again should the financing terms in the international markets dramatically worsen. A viable fiscal position and financing terms in the international capital market play an important role in this respect. The effects of fiscal consolidation through cuts in non-productive government spending are expected to result in the lowering of the current account deficit in the next period.

A relatively high rate of export growth of 12.1% and a moderate growth rate of imports of goods and services of 7.0% per year on average, in euro terms, are expected to be achieved in the period 2013-2015. To boost investment activity, most of the imports will focus on capital and intermediate goods. Faster growth of exports than imports will enable the goods and services trade deficit to go down from 16.6% of GDP in 2011 to 12.8% in 2015. The level of the current account deficit (including grants) is expected to drop to 7.0% as a share of GDP at the end of 2015. Lowering of negative net exports of goods and services, primarily as a result of the forthcoming change in the domestic economy's structure, will contribute to reducing external imbalances and risks to the viability of external debt and external liquidity.

In the next three-year period, the inflows to the current account of the balance of payments are expected to come from current transfers, and the outflows, from factor payments. A major item in current transfers is revenue from remittances, while key outflows in factor payments are foreign loan interest payments. Net current transfers including non-interest income from factors are estimated to reach approximately EUR 3.1 billion per year, on average, in the period 2013-2015. The negative balance of net interest payments is expected to reach EUR 1.2 billion in 2015. The net effect of current transfers and net factor payments in the next three-year period will be positive and stable, and it is estimated to amount to approximately EUR 1.1 billion per annum. The surplus of the current transfers balance and net factor payments will cover, on average, 41% of the Republic of Serbia's foreign trade deficit in the period 2013-2015.

Graph 5. Current Account Deficit and Its Funding, % of GDP



Projections of the current account balance are derived from projected foreign trade movements, current transfers and net factor revenues. The current account balance excluding grants will be negative, and it will amount to EUR 2.6 billion, on average, in 2013-1015. The current account deficit will be funded from foreign investment and loans. Annual net foreign direct investment and portfolio investment, following a brief standstill in 2012, are expected to reach around EUR 2.3 billion on average in 2013-2015.

The Republic of Serbia's total external debt in the period 2013-2015 is expected to go up largely due to growing external debt in the public sector. Priority in drawing funds from external sources will be given to the financing of national infrastructure projects. Private investment is expected to contribute to the overall investment growth in 2014 and 2015. After the 2012 increase, the Republic of Serbia's total external debt as a share of GDP will go down in the next three-year period to reach approximately 85% in 2015. Furthermore, it is estimated that the external debt repayment to GDP ratio and the external debt repayment to export ratio will gradually decrease, whereas the interest ratios will slightly grow. The ratio of the public external debt to GDP will be declining primarily as a result of the partial sale of state assets. The proceeds from the sale of sate-owned companies, which have competition in the market, will be partly used to repay liabilities denominated in foreign currency.

The Republic of Serbia's foreign exchange reserves in 2013-2015 will cover seven-month imports of goods and services.

Viability of the Republic of Serbia's External Position

Medium-term and long-term viability of Serbia's external position will greatly depend on the recovery in the euro area and fresh inflows of foreign direct investment, as well as on the competitiveness of domestic exports. The implementation of structural reforms, successful implementation of the fiscal consolidation plan, halting of the public debt growth and its long-term stabilisation at the level of below 45% of GDP are also essential, as they will have bearing on country risk premium and borrowing costs.

As far as the viability of external position is concerned, external liquidity of the country is stable –short-term external debt coverage with foreign exchange reserves rose considerably in 2012 (2.710% in the third quarter of 2012, as compared to 1.860% in late 2011). In the third quarter of 2012, the ratio of external debt repayment to export of goods and services dropped to 25% (from 34% in late 2011). Imports coverage with foreign exchange reserves amounted to 6.9 months in the third quarter. The country's financial openness as measured by the Grubel-Lloyd index saw a slight fall to 0.58 in the third quarter of 2012, as compared to end-2011.

A high and growing ratio of the total external debt in the international investment position to GDP in 2012 (nearly 100% in end-September) poses a risk to the country's external solvency.

The level of economic openness to the world was up thanks to considerable growth, primarily, in exports of goods and services. In the situation of public debt crisis in the euro area, the volume of the Republic of Serbia's foreign trade increased to 101.1% of GDP.

Although the Republic of Serbia was the only country in the region whose credit rating was upgraded in March 2011 from BB- (stable) to BB (stable), in early August 2012, Standard and Poor's downgraded the credit rating of Serbia's long-term sovereign debt in foreign and domestic currencies to BB- with a negative outlook, taking into account the growing trade and fiscal deficits and vulnerability of the domestic economy. In mid-August 2012, the Fitch rating agency kept BB-rating of Serbia's long-term sovereign debt, but they downgraded Serbia's rating outlook from stable to negative as a result of worsening fiscal situation and the country's position with respect to external financing and poor economic growth prospects.

The level of the NBS's foreign exchange reserves, level of banking sector's liquidity and capitalisation, legal framework and the measures to be taken with respect to non-performing banks will have bearing on the viability of Serbia's external position in the next period. Also, change of the economic growth model and reallocation of the available resources to industries that can boost production and exports will help to improve the country's external position.

Enhanced price and cost competitiveness is of particular importance to the viable external position. The economy's price and cost competitiveness in 2013 and the following two years will depend, first of all, on the movements in the dinar exchange rate, wages, labour productivity and inflation. Also, fiscal consolidation includes measures that improve competitiveness of domestic producers, thus increasing aggregate demand through the increase in net exports.

Competitiveness of domestic exports as measured by the effective dinar exchange rate was down in 2011 and 2012. The real effective dinar exchange rate calculated on the basis of the consumer price index (CPI), as a key measure of export's price competitiveness, appreciated cumulatively by 4.4% in 2011. Real appreciation was also achieved in 2012, when it amounted to

1.5%. While in the first half of the year a slight real depreciation was achieved as a result of nominal dinar depreciation in comparison to currencies in the basket, the second half of 2012 was marked by the beginning of intense real appreciation (8.8%), which, in addition to nominal appreciation, was a result of the significantly higher inflation rate in Serbia than in its trading partners. Consumer price growth is expected to slow down in 2013, stopping the real appreciation trend, which could otherwise have adverse effect on exports.

As regards the country's cost competitiveness, in 2011, real effective exchange rate as measured by unit labour costs in industry (ULC) appreciated by about 10% towards the end of the period (9% on average), while, according to the latest available data, real appreciation of 6.2% (0.2% on average) was marked in the first three quarters of 2012. In the export breakdown by destinations, dominant export partners are the EU countries, with the total share in Serbia's exports of 58.6% (56.0% in the same period in 2011) in the first 11 months of 2012, followed by Russia with the share of 9.9% (12.8% in 2011) and CEFTA countries with 8.3% (8.6% in 2011). In the EU, the most important individual export partners are Germany (11.0%, 10.9% in 2011) and Italy (9.6%, 8.9% in 2011). The Serbian economy seems to be relatively well diversified by product groups. Significant change in the shares of certain industries took place in 2012 as a consequence of a discontinuation of operations at the Smederevo Steelworks; hence, the basic metals account for 9.6% (16.5% in 2011) of the overall export, while the share of car industry went up to 7.3% (from 3.9% in 2011). Other relevant product groups include food industry (13.4%), agriculture (8.6%), electrical equipment (6.9%), metal products (5.6%) and chemicals (5.0%).

The Republic of Serbia's International Investment Position (IIP)

According to the NBS, the Republic of Serbia kept the status of a net capital importer in the period between end-2008 and end-March 2012. The Republic of Serbia's IIP, as a net debtor, was on a steady rise from 2008, and it reached EUR 24,806.9 million at the end of 2011. The Republic of Serbia's IIP was negative in 2011 as a result of rise in external financial assets to EUR 19,484 million and external financial liabilities to EUR 44,291 million. Net inflow of capital from executed transactions led to an increase in net debtor position by EUR 2.7 billion, while currency change, change in the financial instrument prices and other changes led to the decrease in the Republic of Serbia's net debtor position by EUR 42.5 million; EUR 144.8 million and EUR 536.9 million, respectively.

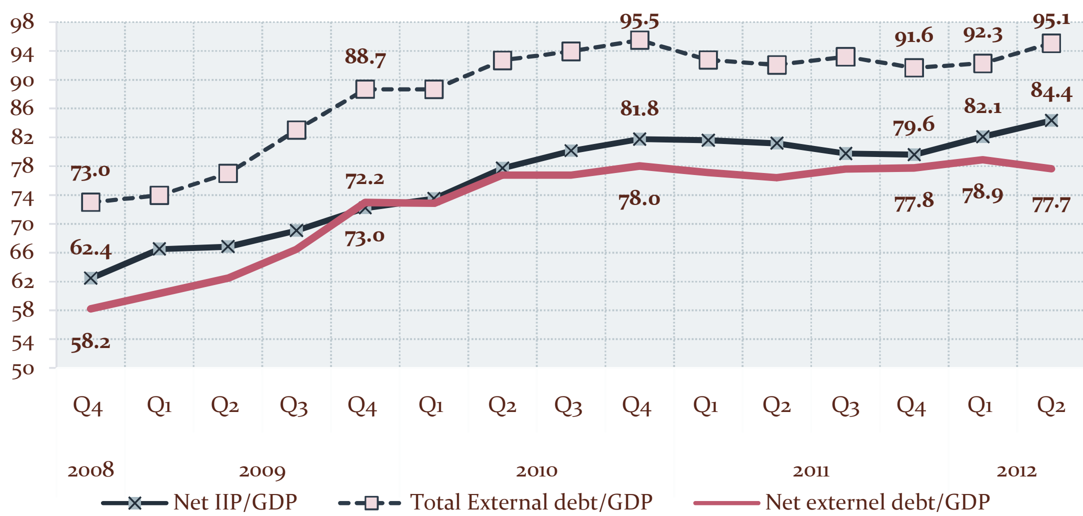
A rise in the net debtor position in 2011 was influenced mostly by the government's external borrowing, primarily, through selling government debt securities to non-residents, but also through borrowings from international financial institutions and foreign-government development banks to finance programmes or projects. In 2011, the international financial position of the banking sector, as a net debtor, was up by 3.5%, and of other sectors - mainly business sector as the greatest net debtor - by 8.2%.

The country's negative international investment position (IIP) increased as of September 2012 in relation to the end of the previous year from EUR 24.8 billion to EUR 25.7 billion. External financial assets went down in the same period by 7.1% to EUR 18.1 billion and external financial liabilities went down by 0.1% to EUR 43.9 billion. This is largely a result of the National Bank of Serbia's IIP, as a net creditor, that fell by 21.1% to EUR 8.2 billion and the negative IIP of the public sector, as a net debtor, that rose by 4.3% to EUR 10.3 billion. In the same period, negative IIP of the private sector, as a net debtor, went down, and in particular the banking sector IIP fell by 10.2% to EUR 8.2 billion and the corporate sector IIP, by 4.4% to EUR 15.5 billion.

Viewed by functional breakdown of investments, negative IIP of foreign direct investments declined in the first nine months of 2012 by 1.2% to EUR 14.4 billion. In the same period, negative IIP of the portfolio investments and financial loans was down by 0.9% to EUR 2.9 billion and by 0.2% to EUR 22.0 billion, respectively. Deviation of the FDI, portfolio investment and loan positions from the balance-of-payments flows of these variables in euro terms is a result of foreign exchange differences that affect the IIP.

Of the Republic of Serbia's overall net position, external debt accounts for 96%. The Republic of Serbia significantly increased its external debt in the observed period. The Republic of Serbia's net external debt at the end of March 2012 amounted to EUR 24,550 million, which was an increase of EUR 5,509 million in absolute terms and 29% in relative terms in comparison to end-2008. The Republic of Serbia's net external debt as a share of GDP amounted to 83% at end-March 2012, which was an increase by 25 percentage points in relation to end-2008. The Republic of Serbia's net external debt in *per capita* terms amounted to EUR 3,362 in the first quarter of 2012, which was an increase of EUR 772, or 30%, in comparison to end-2008.

Graph 6. Serbia's External Solvency, % of GDP



The Republic of Serbia's gross external debt at the end of the first quarter of 2012 reached EUR 28,703 million, which was an increase of EUR 4,818 million in absolute terms, or 20% in relative terms, in comparison to end-2008. The Republic of Serbia's gross external debt as a share of GDP amounted to 97% in end-March 2012, which was an increase of 24 percentage points in comparison to end-2008.

According to the NBS, in the second quarter of 2012, the Republic of Serbia's IIP was up by 0.5% in comparison to the previous quarter, and it amounted to EUR 25,665.6 million, as a result of an increase in the external financial assets to EUR 18,560.5 million and the external financial liabilities to EUR 44,226.2 million. Positive currency changes, change in financial instrument prices and other changes reduced the IIP by EUR 38.5 million, 40.6 million and 450.8 million, respectively. In the third quarter of 2012, the Republic of Serbia's IIP went up by 0.5% in comparison to the previous quarter to reach EUR 25,782.2 million, as a result of a decline in external financial assets by 2.6% and a decline in external financial liabilities by 0.8%. The NBS's IIP, as a net creditor, was down by 3.2%, the IIP of the public sector, as a net debtor, declined by 0.02%, the IIP of the banking sector, as a net debtor, was up by 1.6% and the IIP of other sectors, as net debtors, was down by 1.8%.

The private sector's negative IIP is expected to rise from 2013, mainly due to expected higher inflow of FDIs, provided that the conditions for economic growth are secured and macroeconomic stability is maintained. On the other hand, increased borrowing by the government in the international capital market will result in higher negative IIP of the public sector. The negative IIP is expected to decline from 2014 or 2015, with the implementation of the fiscal consolidation programme.

Financial Sector

This section of the PEP will provide quantitative and qualitative information about the financial sector development and information about the proposals for the financial sector reform, including supervisory and regulatory adjustments.

In end-September 2012, the financial sector's net assets totalled to RSD 3,076 billion, or 94% of GDP. With the net assets of RSD 2,844 billion (92.5% of the overall assets of the financial sector), the banking sector is a dominant component of the financial sector in the Republic of Serbia. Notwithstanding certain growth in the sectors of insurance and voluntary pension funds, the banking sector remains the main intermediary between savers and investors in the Republic of Serbia. Also, all systemic risks arise from the banking sector.

Loans to non-monetary sectors amounted to RSD 1,964 billion and, after excluding foreign exchange rate effects, they marked a year-on-year growth of 6.2%. In a short while, continuing of slow but positive growth of loans could be expected. The ratio of domestic loans to deposits at the end of the third quarter was 1.33, implying that banks manage to lucratively place the collected deposits and to effectively perform their intermediary function in the financial market.

Key risks in the Republic of Serbia's banking sector include credit risk (with special emphasis on a credit and exchange-rate risk arising due to high euroisation level of the financial sector) and the deleveraging risk (which can be considered to be a form of liquidity risk). The NBS regularly performs stress tests every three months to measure the resilience of banks in Serbia to credit risk and liquidity risk. The banks' resilience to credit risk is defined as a change in capital adequacy ratio given the assumed change in the variables that either directly or indirectly influence the level of this ratio (foreign exchange rate, seasonally adjusted gross salaries in dinars, reference interest rate), the foreign exchange rate being the most relevant one.

The main channel through which the foreign exchange rate influences the capital adequacy ratio is the increase in the non-performing loans, which in turn leads to higher regulatory reserves, thereby decreasing capital and, consequently, the capital adequacy ratio. The foreign exchange rate has significant influence on the credit portfolio quality, owing to its currency structure. Loans denominated in or indexed to a foreign currency accounted for 71.8% of total loans to private sector (households and businesses) at the end of the third quarter. As the banks' sources of financing are mainly in foreign currencies, by granting loans with foreign-exchange clauses the banks protect themselves against exchange rate risk, shifting the exposure to borrowers. However, this risk finds its way back into the banks' financial statements in the form of a credit and exchange-rate risk. Namely, by shifting the exchange rate risk to debtors, the banks become exposed to a risk that the debtors whose income is predominantly in dinars will no longer be able to regularly service their debts in case of extreme depreciation of the domestic currency. The corporate sector is additionally exposed to exchange rate risk through cross-border loans, which account for 56% of its total debt and are exclusively foreign-currency denominated.

Beside the foreign exchange rate effect on the growth of non-performing loans, the foreign exchange rate effects are manifested through higher capital requirements to cover the exchange rate risk; revaluation of assets at risk; and the effects on the banking sector's profit, which serves as a buffer for loss coverage. Through all these channels, dinar against euro depreciation would decrease the capital adequacy ratio (from 17.9% at the end of the third quarter) to 15.7% and 13.4% in moderate- and worst-case scenarios, respectively. The moderate-case scenario, in addition to dinar against euro depreciation of 17%, assumes an increase of 17 percentage points in NBS's reference interest rate, while the worst-case scenario assumes the depreciation of 30% and increase in the reference interest rate of 26 percentage points. Both scenarios assume a rise in gross salaries of 6 percentage points.

In the final stage, the credit risk analysis includes determining the non-performing loans as a share of total loans, which would reduce the capital adequacy ratio from the present level to

14.5% and 12%, respectively. The increase in the share of gross non-performing loans in the total loans of 4.3 percentage points, given the depreciation of 23.3%, would reduce the banking sector's capital adequacy ratio to 14.5%, while the increase of 5.6 percentage points, given the depreciation of 39.1%, would reduce it to the level of 12%, which is domestic regulatory minimum.

The liquidity risk is less relevant than the credit risk. Nevertheless, considering the deleveraging trend that is present in all countries of the region and the Republic of Serbia's experience with a major liquidity shock in 2008, the NBS measures the banking sector's resilience to liquidity shocks. The stress tests assume three scenarios according to which the liquidity ratio would fall from the present level of 1.99 to 1.61, 1.53 and 1.27 in soft-, moderate- and worst-case scenarios, respectively. The banking sector as a whole can endure for more than 30 business days in case of deposit withdrawals according to the moderate scenario; and 9 business days, according to the worst-case scenario.

Considering the strong domestic deposit base, the exposure to the deleveraging risk does not give rise to concern. At the end of the third quarter, domestic deposits accounted for 52% of total liabilities, followed by banks' equity, accounting for 21% and banks' external debt accounting for 16%. Nevertheless, further strengthening of domestic sources of financing is recommended and movements in foreign banks' exposure to financial and non-financial sectors are monitored on a regular basis. At the end of the second quarter 2012, the exposure of the member banks of the Bank for International Settlements to Serbia (financial and non-financial sectors) was at 85% of the pre-crisis level (Q3 2008).

In January 2012, Vienna Initiative 2.0 was launched. The second stage of the Vienna Initiative primarily aims to coordinate the bank groups' deleveraging process through cooperation of home county and host country supervisory authorities in order to take a closer look into the systemic risks that might affect the host countries' financial systems. Unlike stage one of the Vienna Initiative, stage two does not aim to maintain a certain level of the banks' exposure to the countries in the region. The goal is to create viable business models for banks, rather than models that depend on external support. This implies greater reliance on local sources of financing, rather than on financing from parent banks.

The regulations governing several segments of the financial system will be amended in order to improve the financial system performance. A new Accounting Law is planned to be enacted in the first and a new Audit Law, in the second quarter of 2013. In the capital market area, the Investment Funds Law will be further harmonised with the EU regulations that need to be implemented in the process of EU integration, in line with the obligations assumed by the Republic of Serbia. Further to the recommendations of the European Commission, harmonisation with the *acquis communautaire* in the area of undertakings for collective investment in transferable securities (UCITS) will be addressed.

The enactment of the Law on Amendments to the Law on Foreign Exchange Operations (*RS Official Gazette*, no. 119/12) provided conditions for further strengthening of the entrepreneurial sector; creating better investment climate; reducing costs and risks of operating and investing in Serbia; and for simplification of the remaining, necessary administrative procedures. Simultaneously, a certain number of by-laws were put out of force in order to reduce regulatory burden. The capital operations, especially foreign credit operations of resident legal persons, branches of foreign legal persons, and individuals, have undergone further liberalisation. Furthermore, the methodology for classification of foreign credit operations has been harmonised with the EU regulations. Residents now have an alternative option to conduct foreign payment operations through a foreign electronic money institution to collect or make payments arising from electronic sale or purchase of goods and services, which aims to facilitate the development of entrepreneurship and small enterprises, and to boost export of services, especially in the area of information technologies. The coming into force of the Amended Tax Procedure and Tax Administration Law (*RS Official Gazette*, no. 93/12) abolished the unnecessary, cost-incurring bureaucratic procedures in foreign exchange operations. The Foreign Exchange Inspectorate has been abolished and its powers have been transferred to the Tax Administration.

The NBS and the Ministry of Finance and Economy are preparing a new Insurance Law, which is planned to be enacted in 2013. This law, along with the NBS by-laws to be drafted based on it, will include provisions which will represent further harmonisation with the most important EU directives governing the insurance area. Harmonisation with the EU regulations will continue in the areas of direct insurance and reinsurance, supervision at an insurance group level, reporting by insurance companies, promotion of risk management in insurance companies, preparation to introduce the capital adequacy concept (strengthening of a company's capital base) and risk-based supervision.

Economic Policy to Support Development Expectations

The projected macroeconomic movements will be supported by active economic policy. The economic policy's top priority in the next medium term will be the country's economic recovery and securing of a sustainable and steady economic growth based on increased investments and exports, which should ensure higher employment and higher living standards and help to address the issue of population ageing in Serbia.

To alleviate the consequences of the second wave of the global economic crisis – especially the crisis in the euro area – for the Republic of Serbia's economy and to provide conditions for economic recovery, an anti-crisis plan for the economy has been adopted. The key measure of the plan is to subsidise interests on business liquidity loans and housing construction loans. In addition, important measures intended to incentivise economic activity and remove burden from the economy include shorter time for collection of claims from the Republic, local self-governments and public enterprises; abolishing of unnecessary parafiscal charges and fees payable by businesses; and abolishing of unnecessary agencies and funds. In the crisis situation, the government will take appropriate steps to boost production and investments, especially in the regions with high unemployment rates. Grants and subsidised loans will be provided to small and medium-sized enterprises, ranging from entrepreneurs dealing in handicrafts to entrepreneurs engaged in information technologies and export of services.

In addition to a short-term programme intended to reduce public spending, relieve the burden on the economy and alleviate the consequences of the economic downturn, a programme of economic policy measures will be adopted to provide for recovery and enhancement of economic activity. With its development-oriented measures, the economic policy will help to boost production, exports, employment and living standards of citizens through the support to the economic activity growth, primarily, in the sector of tradable goods production, especially by investments in agricultural production, coupled with higher yields and a higher level of product finishing, as well as through the support to the development of export-oriented activities, coupled with efficient guarantee mechanisms for export transactions. A special challenge to the economic policy will be financial incentives to businesses for programmes which, using the available resources, produce the best results and help accelerate economic growth and boost employment.

Special incentives will be provided for sectors having comparative advantages, such as agriculture, energy and infrastructure. A new investment cycle will be launched in these sectors, with encouraging and attractive business environment for investors and foreign direct investments; the government with its public investments; and the financial sector and its potential playing key roles in the process, all in the function of economic recovery and growth. Substantial support will be given to sectors where the Republic of Serbia has competitive advantages, including car industry, metal industry, electronics industry, food processing industry and defence industry.

In working to boost the economy, special attention will be paid to creating a stimulating business environment for businessmen and investors; facilitating business activities; stability of the national currency; favourable price of capital; government subsidies to agriculture; and stimulating exports. Economic reforms that remain to be implemented will be expedited to enhance business environment, especially by strengthening the rule of law and removing inflexible labour market conditions. The aim is, through structural reforms, to put in place a business environment that will boost foreign and domestic investments, speed up economic restructuring and enhance productivity and competitiveness of the economy.

The Development Fund of the Republic of Serbia will continue to support small and medium-sized enterprises and investments in under-developed regions of the Republic of Serbia under terms more favourable than those offered in the market. The Export Insurance and Credit Agency will be strengthened through relevant capital increase. Incentives to direct investments will be intensified through the Foreign Investment and Export Promotion Agency. The financial sector potential will be in the function of economic recovery and growth.

Economic recovery and restructuring of the Serbian economy will be greatly assisted by lowering unreasonable public spending and increasing investment spending, which would boost economic growth and employment. Key to this process will be the fiscal policy and stability of the national currency, through effective use of monetary policy tools, active attracting of foreign investments, prevention of foreign exchange outflow through grey channels, providing disincentives to unnecessary imports, and stimulating enterprises to substitute imports and enhance export offers.

Responsible fiscal and monetary policies; active anti-trust, demographic, regional and social policies; and active policies in the sectors of agriculture, industry, energy, infrastructure, health care, education, science and other sectors of relevance for the economic growth in the country will be pursued with the view of achieving economic policy development goals.

The government will implement responsible and foreseeable fiscal policy, in line with the principle of fiscal responsibility and the fiscal rules envisaged under the Budget System Law to reduce the debt-to-GDP ratio.

To achieve macroeconomic stability and economic growth in the next three years, fiscal policy needs to focus on a credible fiscal adjustment programme that will be based on the application of a set of fiscal rules concerning fiscal deficit and public debt. Therefore, the main goal of the fiscal programme is to scale the general-government public debt down to a sustainable level and to create fiscal space for additional investment spending, in view of the needs in the infrastructure sector and other development priorities.

Generally, fiscal policy in the next mid-term period will focus on achieving the following goals:

- Lower public expenditure, fiscal deficit and debt as shares of GDP;
- Maintaining a stable tax burden on the economy, including improved tax compliance;
- Strengthening of fiscal sustainability through structural reforms, especially reforms in the public sector.

The main goal of the mid-term fiscal policy is to achieve fiscal adjustment, which is needed in order to reach the fiscal deficit target, primarily by pushing down the ratio of public spending to GDP, along with adequate changes in the tax policy. Key to the fiscal sustainability in the medium term will be structural reforms of the big and inefficient public sector, and in particular improvement of the pension system, health care, education and public enterprises.

Fiscal adjustment will be carried out mainly through the measures that have an effect of reducing current public spending. The movements in the biggest public spending categories – salaries and pensions – will be restricted by special fiscal rules the application of which will gradually lead to relative decrease of these expenditures as shares of GDP. The remainder of the necessary fiscal adjustment will be carried out by reducing discretionary expenditures, subsidies and loans from the budget. To implement the fiscal adjustment of the necessary scale, saving measures will be taken at all levels of government, from central to local; efficient public procurement process will be put in place; and measures for support to the economy will be redefined, so as to ensure that the limited fiscal incentive funds are directed to the best-performing support programmes.

With limited space for capital investment, priorities should be set in the public investments area, taking into consideration limited funds and investments in projects with the best social benefits to costs ratio. Beside limited domestic sources of financing from the budget, one should bear in mind the level of indebtedness and the fiscal rule that limits the debt ratio to 45% of GDP, so as to set investment priorities that will be financed through borrowings from international financial institutions and bilateral borrowings.

The NBS will, using the monetary policy measures and tools, support the implementation of the economic and fiscal policies defined and pursued by the Government, provided that by doing so the achievement of key monetary policy goals concerning price stability and stability of the financial system are not called into question.

2.1. Macroeconomic Risks

In this part, the PEP presents the main external and internal risks for the materialization of the anticipated macroeconomic scenario.

The key external risk for the materialization of the projection is predominantly related to uncertainties surrounding recoveries in the world economy, in particular the euro area economy. Global economic recovery is slowing down with significant differences in growth rates among groups of countries. The economies of the USA and Germany are posting fairly good growth rates with signals of deceleration, while the EU economies stagnate, and economies in the euro area are in recession. The heightening of the risks surrounding the recovery of the global and European economies, which exerts strong influence on the recovery of countries in the region, is to a large extent exacerbated by the uncertain outcome of the economic and political crisis in the EU, related to the crisis of the euro, the debt crisis in Greece and other Member States of the euro area. Unfavourable trends in the EU have an impact on the deceleration of growth and exports of the countries in Central and Eastern Europe, including Serbia, due to the slackening of export demand and lower capital inflows, as well as due to higher borrowing costs. The recovery of the Serbian economy will very much depend on the recovery of the euro area economies and economies of the region, the picking up in foreign demand and inflows of foreign capital, movements of foreign interest rates, developments regarding import prices, food prices and petroleum product prices.

Internal risks surrounding the materialization of the projection are related to the delays in the implementation of economic reforms and economic policy measures, sudden changes in aggregate demand, acceleration of inflation, sharper fluctuations of the dinar exchange rate against the euro and resulting more serious disturbance on the foreign exchange market, a sharper decline in inflows of foreign direct investment, a rise in the risk premium on foreign loans to local entities, political risks, etc.

The baseline development scenario for the coming three years is based on an increase in the share of fixed capital formation in GDP; a cut in GDP-to-public expenditure ratio; a rise in the share of exports of goods and services in GDP, with a mild decline in the share of the current account deficit in GDP to 7.0% in 2015; the curbing of inflation from 7% in 2011 to 4.5% in 2015.

The key assumptions for the materialization of the anticipated medium-term development scenario include: adjustment of the economic system, macroeconomic policy and sectoral policies to the concept of sustainable and stable economic growth dominated by investment in distribution of GDP, and tradable goods in the structure of the economy; acceleration of economic reforms, particularly of the public sector reform; keeping the pace in convergence to the EU; external debt sustainability and external liquidity.

Departures from the above assumptions pose risks to the materialization of the medium-term macroeconomic projection. Lower-than-projected economic growth rates would deepen the crisis, while a slowdown in the recovery of the world economy, and particularly the recession of the European economy, would adversely affect the recovery of the Serbian economy and economic development of the country, reliant on export demand and investment growth. Economic growth deceleration reduces employment, slows down productivity growth, reduces space for investment and consumption growth, impedes export and import growth, which is translated into cuts in public revenue. Such developments would widen macroeconomic imbalances through a hike in inflation and instability on the foreign exchange market, with the lowering of foreign exchange reserves and problems in the repayment of external debt. Moreover, the necessary investment cycle, based on strong inflows of foreign capital due to low domestic savings and private and public sector investment, would be slowed down and halted. Structural reforms, which create an enabling economic environment, needed for the accomplishment of development goals, establishment of macroeconomic stability and sustainable economic growth, would also decelerate and stop.

III. Fiscal Framework for the Period 2013 - 2015

1. Medium-Term Fiscal Policy Goals

The goal of the fiscal policy in the medium term is to decelerate general government debt increase and to reduce it in relative terms, i.e., to reduce debt as a share of GDP to about 45% over long-term in accordance with the general fiscal rule.

General government public debt in 2012 has risen to 65% of GDP and any failure to implement fiscal policy measures would lead to a debt crisis and a repetition of the Greek scenario. Debt reduction over medium-term will be accomplished through the reduction of consolidated deficit, tax policy and expenditure policy measures. The implementation of most fiscal consolidation measures begins in the last quarter of 2012, due to which the estimated effects in this year are relatively small. The full effect of the measures will be seen in 2013, when the deficit will be halved relative to 2012.

Fiscal consolidation on the revenue side envisages the increase of tax rates for certain income categories, while the expenditure policy will be directed towards reducing the relative share of current public spending.

Deficit reduction in the following period will be achieved through an increase of direct (corporate income) taxes and consumption taxes (VAT, excise), while the fiscal adjustment on the expenditure side will be effected by curbing the rise in wages and pensions as the largest public expenditure categories, as well as by relative reduction of discretionary expenditure categories.

In 2014 and 2015, tax policy will focus on further changes of the tax system in terms of its alignment with the EU legislation, and strengthening tax administration and compliance. Expenditure policy will focus on compliance with fiscal rules relating to wage and pension indexation, but also on further relative reduction of current expenditure, particularly expenditure on subsidies and net lending to businesses, based on the expected completion of the processes of restructuring and privatisation of state and socially owned enterprises.

The 2010 Budget System Law introduced three-year expenditure frameworks aimed at improving the budget process and medium-term planning. This increases the predictability of public finance for budget beneficiaries, but also the transparency of the entire planning process. The introduction of the three-year expenditure framework, by strengthening fiscal discipline should prevent cyclical expansion of public expenditure, that is, a pro-cyclical fiscal policy. The framework of the adopted fiscal strategy for 2013 with projections for 2014 and 2015 also contains expenditure ceilings by budget beneficiary for the following three-year period.

The implementation of the counter-cyclical fiscal policy, in the medium-term, through compliance with the principle of fiscal responsibility and defined medium-term fiscal framework, will contribute to the reduction of debt as a share of GDP. In the long run, the debt is expected to drop to 45% of GDP, in accordance with the Public Debt Reduction Programme.

1.1. Fiscal Framework in the Period 2013 to 2015

Fiscal Trends in 2012

The fiscal deficit of the general government would, in the case of continuing trends from the first half of the year, reach RSD 235.4 billion, or 7.1% of GDP at the end of 2012, and public debt would reach about 65% of GDP. Such unsustainable fiscal position would result in jeopardising budget liquidity and would mark an introduction to a public debt crisis. Putting a stop to such trends required swift fiscal consolidation that would provide for macroeconomic and financial stability on the one hand, and would not hinder economic recovery and exiting recession on the other. With the approval of the supplementary republic budget, fiscal consolidation measures will come into force in the last quarter of 2012, but the true effects will be achieved in 2013.

The current estimate is that the deficit will be 1 percentage point of GDP lower than the deficit that would be reached if it were not for the fiscal consolidation. In addition to the effects of measures that were initially quantified and are shown in the table below, certain macroeconomic variables (foreign trade, exchange rate, inflation, etc.) and effects of some measures which could not be precisely quantified due to their complexity, such as savings from reduction of the highest salaries in the public sector, savings from the closing of certain unnecessary agencies and government institutions and savings in public procurement also contribute to better results.

Table 5. Effects of the Fiscal Consolidation Programme and Impact on the Reduction of Consolidated General government Budget Deficit in 2012, in RSD billion

Revenue side measures	**2012**
Personal income tax (dividends and share of profit, interest income, rates increased from 10% to 15%)	2.2
Corporate income tax (rate increased from 10% to 15%)	0.0
VAT – Increased general rate from 18% to 20%	6.7
Excise duties on cigarettes	4.0
Excise duties on petroleum products	2.8
VAT revenue from higher excise duties	1.0
Total tax revenue	16.7
Expenditure side measures:	
Savings from limited rise of public sector salaries and pensions (October 2%, April 2%)	3.7
Savings from economical planning of expenditure after abolishing own-source revenue of government bodies	3.0
Total expenditure savings	6.7
More efficient collection of non-tax revenue	2.8
Effect on deficit reduction	26.2

Increasing the general VAT rate from 18% to 20%, although necessary at this time primarily as a means of reducing current and future fiscal deficits, demonstrates a commitment to shifting the burden to taxing consumption and not to means of production. A special VAT rate mostly relating to the basic groceries has not changed.

The change of the general value added tax rate is not the only change relating to this tax type. With a view to reducing the fiscal burden, facilitating business operation and improving liquidity of economic operators, reducing the tax burden of businesses and households, and reducing the possibility of tax fraud, several changes have been introduced, of which the most important ones are the following:

- paying VAT upon collection for the taxpayers who have the annual turnover below RSD 50 million;
- introducing a refund of tax on baby products for parents whose income is below average;
- increase of the percentage for VAT compensation from 5% to 8% for farmers and obligation of VAT compensation payment exclusively into the farmer's current account or savings account;
- increasing VAT threshold from RSD 4 to 8 million for mandatory entry into the VAT system;
- increasing the deadline for tax return filing;
- in the case of delay of VAT refund to the taxpayer in future, the interest will accrue at the same rate that applies in the case the taxpayer is late with payment.

The changes provide for the introduction of a system of differentiated excise duties on gas oil (diesel) and liquefied petroleum gas depending on the final purpose. Excise duty on diesel is RSD 42 per litre, but if this fuel is used as motor fuel for transport, farming or heating purposes a reimbursement is introduced for the difference up to the amounts specified in the Law. Similar change is also envisaged for liquefied petroleum gas, and the excise duty has been raised to RSD 30 per kg. There is no differentiation envisaged for excise duty on petrol and the dinar amount will not change. Excise duties on tobacco products have also seen significant changes. Specific excise duty will increase from the present RSD 33 to RSD 43 per pack of cigarettes, and ad valorem excise duty will decrease from 34% to 33%. At the same time a special fee on cigarettes, the so-called "tobacco dinar", is to be abolished. There is a change in the manner of calculating the excise duty on coffee, but there are no significant effects on the volume of revenue. Similarly to the change of VAT rate, the aim of the excise burden increase is to bring a higher inflow of funds into the budget in the following period, but is conceived in such a manner as to burden the production and transport costs as little as possible, while shifting most of the burden to the final consumption.

The amendments to the Corporate Income Tax Law stipulate an increase of the corporate income tax rate from 10% to 15%. This change has come into effect in 2013 so there are no effects on 2012. Amendments to the legislation also provide for the narrowing down of tax incentives to just two: general tax credit for an investment and tax credit for a large investment. In addition, the introduction of the withholding tax on services is also envisaged as an anti-evasion measure, since this tax will be applied to services from the countries that have not entered into a tax treaty with Serbia. Bringing corporate income tax rate close to other types of taxing production should encourage greater employment of means of production, including labour, but also investment.

The amendments to the Budget System Law provide for the abolishment of the own-source revenue of budget beneficiaries, i.e. such revenue is to become general budget revenue. This amendment, although mostly methodological, ensures better control and more economical use of budget funds, which should result in significant savings, particularly from 2013 onwards.

Expenditure side measures provide a balance between the necessary consolidation and prevention of further decline of economic activity and the standard of living of the population. The most important measure is curbing the rise of public sector wages and pensions. The Budget System Law, which regulates wage and pension indexation by special fiscal rules, stipulates that in the case general fiscal rules, i.e. the deficit and debt rules are threatened, special fiscal rules must be adjusted in a way to slow down or stop the breach of general fiscal rules. Special fiscal rules on wage and pension indexation have been changed so that the indexation in October 2012 amounted to 2%, which corresponds to the real capacity of the consolidated budget and creates the conditions for decelerating the growth of expenditures and the related increase of deficit, and, consequently, of the public debt.

In addition, they contain the measures which should assist households and businesses in overcoming the problems brought about by the present economic moment. The pensioners whose pensions are below RSD 15,000 are to receive a payment of aid in the total amount of approximately RSD 8.2 billion, of which RSD 4.2 billion in 2012, aimed at preserving the standard of living.

Towards the end of August 2012, the Government adopted a Plan of Extraordinary Measures for Mitigating the Adverse Effects of Inclement Weather on this year's field and vegetable crops. These measures will provide for the appropriate relief to farmers with a view to reducing the damage caused to the crops, and assistance in the preparation of quality autumn sowing, primarily through subsidising of the purchase of production materials.

Higher subsidies to businesses are envisaged, as well as the funds for settling a part of liabilities for FIAT and a greater part of liabilities for expropriation, to enable the implementation of investment projects of national importance.

The economic crisis in the country and the region, and the unsustainable fiscal position of general government have brought about the changes of tax policy and certain adjustments on the expenditure side of the budget that should ensure unhindered operation of the state and the economy and solve certain problems. Their true effects should be expected in the following medium-term period, when serious fiscal consolidation is expected with the ultimate objective of reducing the public debt to a sustainable level.

1.2. Fiscal Projections in the Period 2013 to 2015

Medium-term fiscal projections have been made in accordance with the general fiscal rules, relating to target deficit and general government debt. Fiscal rules determine the target medium-term fiscal deficit, as well as the maximum debt-to-GDP ratio with the aim of ensuring long-term sustainability of the fiscal policy in the Republic of Serbia. Two general fiscal rules have been defined:

1) target annual fiscal deficit will amount to 1% of GDP in the medium term;
2) general government debt, excluding the liabilities arising from restitution will not exceed 45% of GDP.

To ensure that the actual fiscal deficit in the medium term is equal to the target, and to allow at the same time for the implementation of the anti-cyclical fiscal policy, the following formula will be applied to determine the fiscal deficit in year t:

$$d_t = d_{t-1} - a(d_{t-1} - d^*) - b(g_t - g^*)$$

where d_t and d_{t-1} denote the deficits in years t and t-1 respectively, d^* is the target fiscal deficit set at 1% of GDP, g_t is the real GDP growth rate in year t, and g^* is a potential medium-term real GDP growth rate.

The deficit in the formula is expressed in percent of GDP, while GDP growth rates are expressed in percent. The adjustment coefficient a indicates the speed at which the actual deficit approximates the target deficit, and coefficient b indicates how much fiscal deficit in year t deviates from the target deficit due to the deviation of GDP growth rate in year t from the potential GDP growth rate. The numerical value of the coefficients is set at a =0.3 and b =0.4 while the potential GDP growth rate, g^*=4%. In the circumstances of a growing debt, the target fiscal deficit needs to be additionally adjusted, particularly in the event that the anti-cyclical policy has not produced expected results. Otherwise, fiscal deficit may rise and debt may accumulate.

It is estimated that in 2012 the total consolidated deficit would reach a record 7.1% of GDP, while at the same time the general government debt as a share of GDP would be about 66%. Such a fiscal scenario significantly differs from the initial plan for 2012. A deterioration of the fiscal position is partly a consequence of the changed macroeconomic framework (at the expected growth of 1.5% of GDP the estimated fiscal deficit would amount to 4.3% of GDP), and partly a result of the expansive fiscal policy. In light of the unsustainability of such fiscal policy, the new government adopted a Programme of Fiscal Consolidation Measures to be implemented as from the last quarter of this year. To stop further debt increase, this Programme envisages substantial fiscal adjustment in the following three-year period.

Table 6. GDP Growth and Fiscal Result Trends, 2013 – 2015, in % of GDP

	2013	2014	2015
Fiscal deficit, in % of GDP	3.6%	1.9%	1.0%
Real GDP growth rate	2.0%	3.5%	4.0%

Source: MFE

Even in the case of higher GDP growth rates, the present stock of debt requires a strong turnaround and change of the fiscal policy direction towards the measures that bring the actual fiscal deficit closer to the targeted one in the medium turn since the formula defines the maximum level of deficit. The Fiscal Strategy establishes the fiscal framework which brings the 2015 deficit down to 1% of GDP, to regain the stability of public finance and ensure sustainable debt financing. The table also shows the primary result which is obtained when the interest income and expenses are deducted from the total result. According to the projection, primary surplus is achieved in 2014.

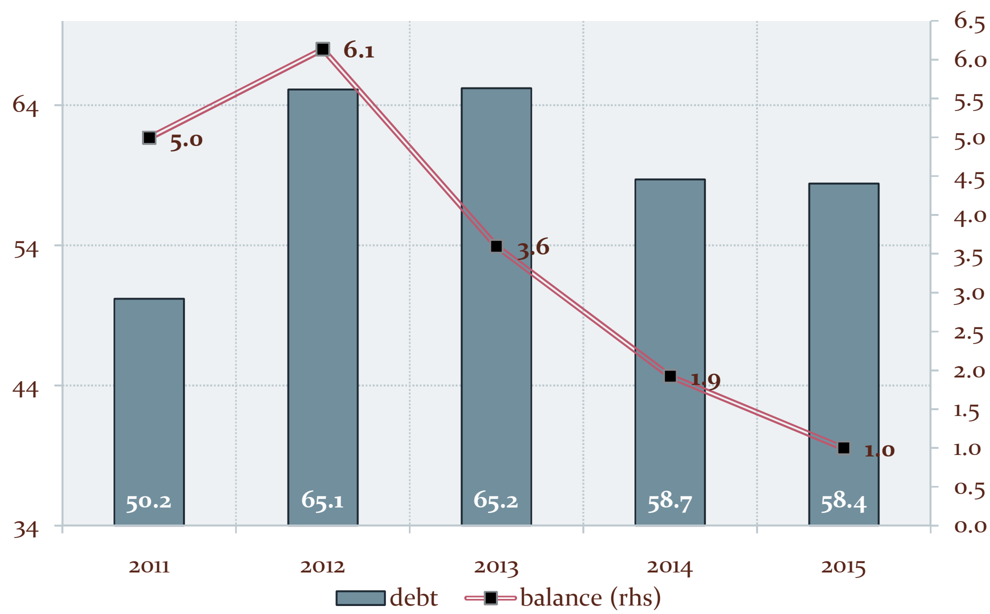
Table 7. Basic Fiscal Aggregates, 2012-2015, in % of GDP

	estimate	projection		
	2012	2013	2014	2015
Public revenue	43.7	44.1	44.1	43.7
Public expenditure	49.8	47.7	46.0	44.7
Consolidated fiscal result	-6.1	-3.6	-1.9	-1.0
Primary consolidated result	-4.1	-1.1	0.6	1.2
General government debt	65.1	65.2	58.7	58.4

Source: MFE

Projections of fiscal aggregates in the period 2013-2015 are based on the projections of macroeconomic indicators for the period, tax policy changes, expenditure side measures, and the effects of structural reforms, which results in decreasing public spending as a share of GDP and reducing general government deficit to 1.0% of GDP at the end of the period under review.

Figure 7. Debt and Deficit in % of GDP



The Table below shows the effects of tax measures in 2013. The effects of tax measures in 2013 reduce the deficit by slightly more than 2.0% of GDP, while the expenditure side savings reduce the deficit by 1.3% of GDP. The effects of expenditure side measures will be even greater as some measures, such as savings from decreasing the highest salaries in the public sector, savings from the closing of certain unnecessary agencies and government institutions and savings in public procurement could not be precisely quantified in a short period of time.

Table 8. Effects of the Fiscal Consolidation Programme and Impact on Reduction of Consolidated General government Budget Deficit in 2013, in RSD billion

Revenue side measures	**2013**
Personal income tax (dividends and share of profit, interest income, rates increased from 10% to 15%)	6.5
Corporate income tax (rate increased from 10% to 15%)	23.0
VAT – Increased general rate from 18% to 20%	33.8
Excise duties on cigarettes	6.8
Excise duties on petroleum products	2.5

Revenue side measures	2013
VAT revenue from higher excise duties	1.8
Conditional tax amnesty (minimum effect)	3.5
Total tax revenues	77.9
Expenditure side measures:	
Savings from limited rise of public sector salaries and pensions (October 2%, April 2%)	26.5
Savings from economical planning of expenditure after abolishing own-source revenue of government bodies	20.0
Total savings on expenditure	46.5
More efficient collection of non-tax revenue	12.0
Effect on deficit reduction	135.4

Total general government revenue, excluding indirect beneficiaries, ranges between 43.7 and 44.1% of GDP, and is expected to stabilize at 43.5% of GDP in the long term.

Table 9. Total Revenue and Grants in the Period 2012 – 2015, in % of GDP

	estimate	projection		
	2012	2013	2014	2015
PUBLIC REVENUE	43.7	44.1	44.1	43.7
Current revenue	43.6	44.0	44.0	43.6
Tax revenue	38.2	38.9	39.3	39.1
Personal income tax	5.1	5.1	5.4	5.4
Corporate income tax	1.7	2.1	2.2	2.2
Value added tax	11.5	11.8	11.6	11.6
Excise duties	5.9	6.3	6.4	6.4
Customs duties	1.1	1.0	0.9	0.8
Other tax revenue	1.3	1.2	1.2	1.2
Contributions	11.6	11.3	11.5	11.5
Non-tax revenue	5.4	5.1	4.8	4.5
Grants	0.1	0.1	0.1	0.1

Source: MFE

Personal income tax. Personal income tax is projected at 5.1% of GDP in 2013 to subsequently go up to 5.4% of GDP taking into account expected changes to the taxation of natural persons' income. Certain effect is also expected from the conditional tax amnesty, since personal income tax makes up a significant portion of the tax debt. The most important personal income tax type is the wage tax. The wage tax revenue trend depends on the wage bill and employment trends. As wages are expected to rise in keeping with rising productivity, and as the rate of employment is expected to improve moderately, it is realistic to expect that revenue from personal income tax will have a stable share in GDP in the following period, or rise slightly in the case of tax policy changes.

Social contributions. Social contributions are the largest single type of public revenue, after the value added tax. The share of contributions in GDP is around 11.5% and the trend of this particular public revenue is similar to that of the income tax. Enhanced tax compliance, conditional tax amnesty and changes in the system of collection and audit will make it possible to achieve the projected values. The surge of this revenue share in GDP from 2014 onwards is the result of better collection, which should be enabled by the start of operation of the Central Mandatory Social Insurance Registry. The assumptions on wage and employment trends in the following medium-term period were used for the projection of contributions.

Corporate income tax. Amendment to the Corporate Income Tax Law provides for an increase of the corporate income tax rate from 10% to 15%. In addition, it also provides for important changes in exemptions from the payment of this tax, so its share in GDP is expected to significantly increase in the following period. The estimated effect in 2013 is about RSD 23 billion, so the share of this tax in GDP will be about 2.2% in the following period.

Value added tax. VAT is projected at 11.8% of GDP in 2013 since the general rate has increased from 18% to 20%, and during the following two years its share of GDP should stabilize at 11.6%. VAT comprises two components, the import and domestic one. VAT realized on import of goods and services accounts for about 70% of the total VAT, and the projection is based on import and exchange rate trends, and the assumptions concerning the effects of implementation of the Interim Agreement on Trade. Domestic VAT is projected on the basis of private consumption trends in the following period and accounts for about 30% of total value added tax revenue. The increase in the share of this tax type in GDP is also a consequence of a faster growth of imports relative to nominal GDP, but also of the real growth of personal income in the following period. Strengthening tax compliance is one of the assumptions on which the projection of this tax type has been made. A slower growth of this tax type or its reduced share of GDP is also explained by changes in the structure of consumption, faster growth of exports and increasing investment activity as the ultimate objective of economic policy.

Excise duties. The projection of excise revenue has been made on the basis of changes to excise policy in 2012, projected consumption of excise duty products (petroleum products, tobacco products, alcohol and coffee), and regular adjustment of the nominal amount of excise duty to the inflation in the previous year. Within the excise policy for all excise products, further gradual harmonization with EU Directives is expected in the following medium-term period. It involves adopting a medium-term plan for gradual increase of the excise burden. In the case of cigarettes, it will be carried out through the specific excise duty to reach the EU minimum of EUR 1.8 per pack of the cheapest cigarettes by the year 2020, and in the case of the other tobacco products through an increase of minimum excise duty to gradually align their excise burden with that on cigarettes and avoid the changes in the structure of demand that would affect tax revenue and be contrary to public health policy goals.

In the case of excise duties on petroleum products, the introduction of a system of differentiated excise duties on gas oil (diesel) and liquefied petroleum gas depending on the final purpose is provided for. If the fuel is used as motor fuel for transport, farming or heating purposes a reimbursement is introduced for the difference up to the amounts specified in the Law. There is no differentiation envisaged for excise duties on petrol and the aim is to align the excise duties on diesel and petrol for passenger cars.

With regard to the excise duty on alcoholic beverages, a gradual harmonization of excise taxation of all alcoholic beverages according to the percentage of alcohol content is envisaged.

Customs duties. The projection of customs revenue is directly linked to the volume and structure of imports. Taking into account that the Interim Agreement on Trade with the EU has been in force since 2009, and that in the meantime free trade agreements with Turkey (2010) and EFTA countries (in 2010 –Switzerland and Liechtenstein, in 2011 - Iceland and Norway) have come into force, the share of such revenue in GDP has been and will be decreasing up to and including 2013, when the harmonization of customs duty rates needs to be completed under the Interim Agreement on Trade with the EU and Free Trade Agreement with EFTA countries, or up to and including 2014, under the Agreement with Turkey. In addition, short-term customs policy measures relating to tariff concessions on the imports of raw materials, intermediates and equipment envisaged for 2013, will also result in reduced customs revenue, albeit to a lesser extent. Thereafter, this revenue is expected to stabilize relative to GDP. Croatia's joining the EU in 2013 will lead to a slight rise of customs revenue as withdrawal of this country from the CEFTA Agreement will raise certain tariff rates (for example, the rate on tobacco product imports).

Other tax revenues. These revenues, a considerable part of which is the property tax and the taxes on use, holding and carrying goods, are projected in line with the nominal GDP growth. The level of such revenues is relatively stable, and for the most part they do not exhibit a marked response to a decline in economic activity. This is the reason why at the time of a major crisis and slower growth of other tax revenues, the share of this category increases to an extent. In the medium-term period characterized by economic growth, the share of other tax revenues stabilizes at a lower level.

Non-tax revenue. Non-tax revenue as a share of GDP will drop over medium term. This is due to the fact that in 2012 and 2013, a major inflow of funds belonging to the budget but no paid due to procedural reasons (funds arising from bankruptcy of socially-owned enterprises, succession, etc...) is expected. Such one-off revenue is lower in 2014 and 2015 so the entire category of non-tax revenue is expected to decrease in relative terms.

In addition to the changes in tax rates and tax base, the Law on Conditional Write-off of Interest and Moratorium on Tax Debt will also have a significant effect on both the revenue collected and compliance strengthening, as well as on addressing the issue of illiquidity in the economy. According to the proposed law, the taxpayers regularly discharging their current liabilities would have their interest owed conditionally written off, and their principal debt would be suspended for up to two years. Once the conditions for interest write-off are met, the taxpayers will be allowed to pay the principal tax debt in 24 monthly instalments, discharging their current liabilities at the same time. The minimum effect of this measure in 2013 is estimated at 3.5 billion dinars.

Table 10. Total Expenditure[1] in the Period 2012 – 2015, in % of GDP

	Estimate	Projection		
	2012	2013	2014	2015
PUBLIC EXPENDITURE	49.8	47.7	46.0	44.7
Current expenditure	45.7	43.8	42.2	40.8
Compensation of employees	11.5	11.0	10.9	10.8
Purchase of goods and services	7.6	7.1	6.9	6.7
Interest payments	2.1	2.6	2.6	2.3
Subsidies	3.4	3.2	2.9	2.6
Social benefits and transfers	20.0	18.8	18.1	17.6
Of which pensions	*14.5*	*13.6*	*13.2*	*12.8*
Other current expenditure	1.1	1.0	0.9	0.8
Capital expenditure	3.5	3.6	3.5	3.7
Net lending	0.5	0.3	0.2	0.2

Source: MFE

Fiscal adjustment on the public expenditure side in the period under review is 5.1 percentage points. The largest portion of the adjustment relates to current spending, thus avoiding a drop in the share of public investments in the following medium-term period. Special fiscal rules ensure that the reduction of fiscal deficit relative to GDP is indeed achieved in this way.

Implementing fiscal adjustment to the extent needed requires austerity measures at all levels of government, both central and local, the completion of restructuring process in socially-owned and public enterprises, a concrete structural reform programme, more efficient public procurement process, redesigning measures of support to the economy so that significantly restricted funds for fiscal incentives are directed towards the support programmes that achieve the best results in terms of encouraging economic growth and reducing unemployment.

Compensation of employees. Public sector wages are indexed, under the fiscal rules, to the inflation and a part of GDP growth in the preceding year. By way of exception, in 2013, the first indexation (in April) will be at the level of 2% (the same as in October 2012) regardless of the inflation trend and economic growth. Thereafter, starting from October 2013 indexation, wages will be indexed in accordance with fiscal rules. Taking into account the projected inflation in the period under review, the share of compensation to employees in GDP is expected to decrease.

[1] Excluding indirect budget beneficiary expenditures

Wage indexation under the special fiscal rule is expected to last until the share of such expenditure reaches 8% of GDP.

Purchase of goods and services. A significantly reduced share of this category of expenditure in GDP is envisaged, meaning that a greater part of fiscal adjustment on the expenditure side, aimed at achieving the planned deficits, will be accomplished by the savings in this category of expenses. Several factors will contribute to this: abolishment of own-source revenues will enable more economical and efficient management of budget funds and control thereof, bring order to the public procurement process, and slow down of inflation.

Interest payments. In 2012, the cost of interest has reached an alarming level exceeding 2% of GDP. The overly high public debt will result in the share of interest in GDP of 2.6% by 2014. Considering that fiscal consolidation, an important part of which is the sale of parts of government assets, will lead to a decrease of public debt, a significant drop in interest, in both relative and absolute terms, is expected from 2015 onwards.

Social benefits and transfers to households. The largest category of transfers to households is pensions. Under the Budget System Law and the special fiscal rule regulating pension indexation, in the period 2013-2015 pensions should be indexed to CPI plus a part of real GDP growth, if it exceeds 4%. As in the case of public sector wages, in October 2012 and in April 2013 indexation will be fixed at 2% regardless of the inflation trend and economic growth. Thereafter, from October 2013 onwards, pensions would be indexed in accordance with fiscal rules. In 2012, the share of pensions in GDP is 14.5%, and the target set by fiscal rules is to reduce the share of pensions in GDP to 10%. During the following medium-term period, this ratio is expected to drop to 12.8%, aided in addition to fiscal rules, by a decelerated rise in the number of pensioners as a result of parametric pension system reforms, which have already begun to produce results. In the course of 2013, persons receiving a pension below RSD 15,000 will be paid the other two instalments of the social benefit, which would amount to RSD 4.2 billion in total. Other forms of social benefits and transfers to households in the period between 2013 and 2015 will be adjusted applying the prescribed indexation, current and planned changes to policies in this area and the projected number of beneficiaries. The Application of the above rules will bring the share of this category of expenditure down from 20.0% of GDP in 2012 to 17.6% in 2015.

Subsidies and net lending. Fiscal adjustment in the period under review will for the most part be implemented by reducing the amounts for subsidies and net lending. The prerequisites for the reduction of these expenditures are: completing the restructuring process in socially-owned and public enterprises, a concrete structural reform programme, as well as redesigning measures of support to the economy so that significantly restricted funds for fiscal incentives are directed towards the support programmes that achieve the best results in terms of encouraging economic growth and reducing unemployment.

Capital expenditure. A decrease in current spending of the general government creates room for maintaining public investment at the average level of 3.6% of GDP in the following medium-term period. Considering that funds are limited, investments of national importance (Corridors X and XI) will have special importance. Any significant increase of the capital expenditure share in the circumstances of fiscal consolidation requires a stronger and more dynamic economic growth.

1.3. Debt Reduction Programme

In line with the fiscal responsibility principle, if the general government debt[2] exceeds 45% of GDP, the Government is obligated to propose measures that will bring the debt closer to the

[2] The need to adopt a Public Debt Reduction Programme is stipulated in the Republic of Serbia Budget System Law. The Law provides for a definition and coverage of public debt (which includes general government debt plus any guaranteed liabilities), as well a fiscal rule stipulating that the debt may not exceed 45% of GDP. Due to the fact that this ceiling has been breached, the Programme has become an integral part of the adopted Fiscal Strategy and

target level, or return it to a sustainable range. The present level of debt and, even more so, the trend it is exhibiting, are fiscally unsustainable. It is estimated that in unchanged circumstances the general government deficit in 2012 would be 7.1% and that public debt would reach the level of about 66% of GDP. Since the implementation of the fiscal consolidation programme will start in the last quarter of this year, general government deficit is estimated at 6.1% of GDP. At the same time, public debt will reach 65.1% of GDP. Such level of debt, as a consequence of large deficits, increasing borrowings guaranteed by the Republic of Serbia and the adverse impact of the dinar depreciation against the euro and the dollar, can threaten the financial stability in the medium and long term. This has given rise to an urgent need for the measures that will reduce the deficit over the medium and long term, which will, in turn, reduce the need for government borrowing and, consequently, the relative share of debt in GDP.

The Programme of Fiscal Consolidation Measures and Fiscal Framework in the period 2013-2015 envisage a drop in consolidated fiscal deficit to 1% in 2015. Accordingly, in the following three years, this fiscal consolidation programme should be treated as a basis and an integral part of the public debt reduction programme.

In the period 2013 to 2015 the share of public debt in GDP starts to drop to reach 58.4% at the end of period, primarily as a result of fiscal consolidation measures and reduction of fiscal deficit, but also, to an extent, of financial market operations. The government plans to offer by means of public invitation to tender some state-owned enterprises for sale (in the case of achieving an acceptable price) which are exposed to competition (and do not belong to state monopolies), as well as a part of unemployed government assets. Proceeds from the sale will partly be used for repayment of liabilities in foreign currency and the remaining portion for repayment of securities issued on the domestic market. Since the public debt level will not reach the target value of 45%, the programme of fiscal consolidation and reduction of fiscal deficit will need to continue for a long time past 2015.

Table 11. Public Debt Simulation in Baseline Scenario until 2020

Baseline scenario	2012	2013	2014	2015	2016	2017	2018	2019	2020
Revenue	43.7	44.1	44.1	43.7	43.5	43.5	43.5	43.5	43.5
Expenditure	49.8	47.7	46.0	44.7	43.5	43.1	42.7	42.5	42.4
- expenditure side adjustment		*-2.6*	*-1.6*	*-1.3*	*-1.2*	*-0.4*	*-0.3*	*-0.2*	*-0.2*
Fiscal result	-6.1	-3.6	-1.9	-1.0	0.0	0.4	0.8	1.0	1.1
Public debt to GDP	65.1	65.2	58.7	58.4	56.9	54.0	51.0	48.0	45.0
Real GDP growth	-2.0	2.0	3.5	4.0	4.0	4.0	4.0	4.0	4.0

The Baseline Scenario (Scenario number 1) envisages a reduction of the public debt to 45% of GDP by 2020. The basic assumptions in this scenario are:

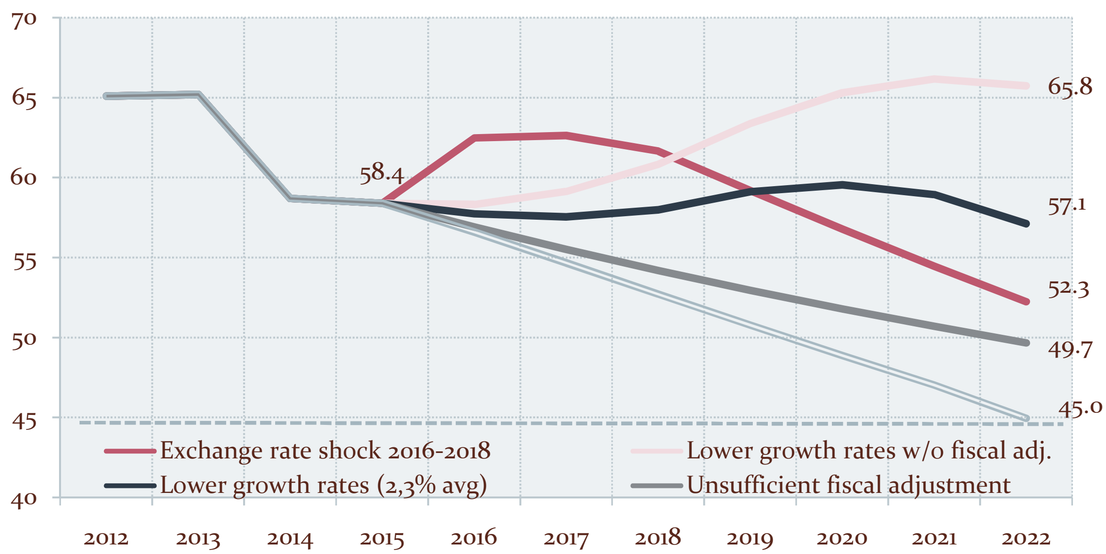
- additional fiscal adjustment of target fiscal deficit by 0.75 percentage points of the result set by the fiscal rule;
- 43.5% average share of 43.5% of public revenue in GDP in the period under review;
- a ceiling for newly issued guarantees of 1% of GDP per annum;
- real growth of GDP of 4% per annum in the period between 2016 and 2022;
- average nominal change of the exchange rate of 2% per annum in the period under review;
- no significant adverse effects on interest rate trends;
- no significant inflows from privatization in the period 2016 to 2020.

In such a scenario, the heaviest consolidation burden falls in the period between 2013 and 2016 when the fiscal adjustment is greatest on the revenue side, from 2.6% to 1.2% annual

Pre-Accession Economic Programme. The values given here and in the Public Debt Management chapter represent the amounts of debt projected at the moment of adoption of the 2013 Fiscal Strategy.

reduction of the share of expenditure in GDP. Thereafter, the expenditure side adjustment is considerably smaller, and the fiscal balance is positive. The fiscal surplus would, according to this programme, would be 0.8%, on average, in the period 2017 2020.

Figure 8. Comparison of Various Scenarios and Impact on the Level of Public Debt



Alternative scenarios and their impact on the level of public debt at the end of period are given on the basis of assumptions on GDP growth and target deficit adjustments.

Scenario number 2 assumes the same growth rates as the baseline scenario, but no additional adjustment of the target deficit which arises from the fiscal rule;

Scenario number 3 assumes growth rates that almost halve after 2016, with a crisis that hits in the period 2017 - 2020, with the deficit adjustment from the fiscal rule of 0.6 percentage points, but which is not sufficient to result in a reduction of the public debt level;

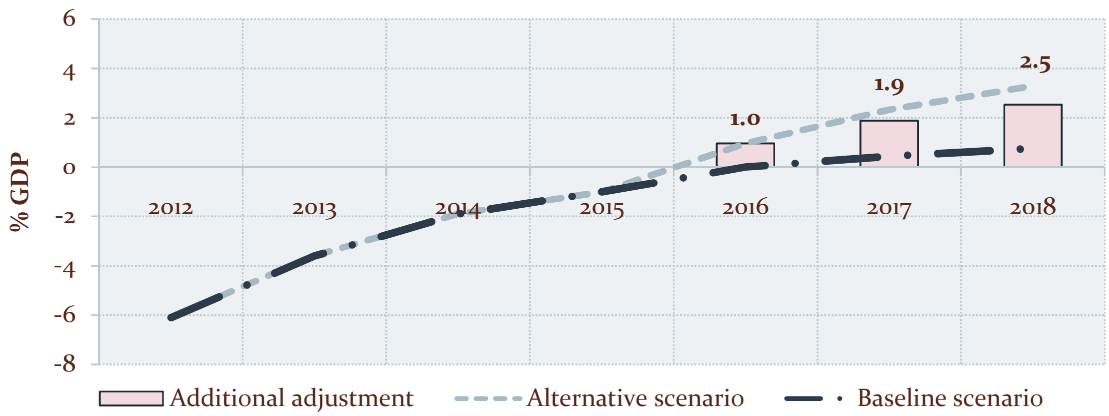
Scenario number 4 assumes decelerated growth as in the previous scenario, but with no additional fiscal rule adjustment, that is, with a lack of any fiscal consolidation whatsoever;

Scenario number 5 involves the same assumptions as the baseline scenario, but with a shock on the exchange rate side in the form of the dinar depreciation between 15% and 5% in the period 2016 - 2018.

For the sake of comparison, if the objective were to reduce debt to 45% of GDP in 2018, a much stronger fiscal adjustment would be needed and achieving a fiscal surplus of about 3.3% of GDP in that year as shown in the following Figure. Two variants of projected fiscal results are shown, of which the baseline scenario is in line with the debt reduction program, while the alternative scenario assumes bringing debt down to 45% of GDP in 2018. For this to be achieved, a much greater fiscal adjustment is required, that is, achieving such a result in 2018 would require an additional adjustment of 2.5% of GDP, which is approximately RSD 138 billion, and a total of RSD 277 billion of cumulative adjustment in the period 2016 - 2018. This is the amount by which revenue would need to increase, or expenditure decrease, or for which a combination of measures on the revenue and expenditure side would need to be devised.

The fiscal policy past 2015 must also focus on further deceleration of debt growth, by reducing the relative share of deficit in GDP, through fiscal adjustment on the expenditure side. It is important to note that adequate control and monitoring of new guarantee issuance will contribute to the successful implementation of this programme. A preconditions for retaining the issued guarantees at the level determined by this programme is the improvement of the monitoring, risk assessment and investment project prioritisation process.

Figure 9. Fiscal Adjustment Depending on the Pace of Public Debt Reduction



A scenario in which the Government would depart from the fiscal framework set by this strategy including, in addition to fiscal consolidation measures, continued implementation of structural reforms, could lead to a public debt crisis and macroeconomic instability. Preventing of the debt crisis and slowing its growth can be achieved only through a drastic reduction of deficit as early as 2013, by applying fiscal consolidation measures, but also by continued implementation of the reforms which will result in the recovery of public finance in the medium turn.

1.4. Fiscal risks

Public finances of the Republic of Serbia are facing numerous risks in the following medium-term period, which makes the fiscal position of the country highly unstable. Fiscal risks are considered to be any circumstances which, if they occur, would result in a significantly lower revenue or higher expenditure. The achievement of the envisaged volume of revenue and expenditure depends on the success of the fiscal policy to minimize the probability of a risk occurring. The success in fiscal risk management depends on political, macroeconomic and social circumstances in the country and in the region.

Drop in economic activity. A negative scenario which in the following period involves a drop in economic activity or a smaller growth would result in a significant drop in the inflow of capital, reduced foreign trade and, based on the smaller volume of activity, in the narrowing of the current account deficit. In such a case the revenue would be lower and, consequently, the deficit higher unless additional adjustment is made on the expenditure side. A GDP growth lower by 1 percentage point would result in lower tax revenue by about 0.4% of GDP.

Lower tax revenue. Tax revenue, in addition to economic activity, is affected by a large number of factors. Many changes to tax policy, implementation of new tax procedures, tax amnesty effects, company profitability in the previous year are just some of the factor that may affect tax revenue collection. Adverse effects of these factors may reduce tax revenue by maximum 0.5% of GDP.

Inflation. Inflation is an important determinant of both revenue and expenditure trends. Inflation higher than projected would affect the growth of both the revenue and expenditure side of the general government budget. Since the inflation is the main determinant of the wage and pension trends which account for more than 50% of general government expenditure, higher inflation will lead to higher expenditure, i.e. any inflation rise above the projection by 1 percentage point would lead to a deficit increase of 0.1 percentage point in 2014 and 2015. This would not particularly affect 2013 as the first wage and pension indexation has been fixed at 2%.

Collection of contributions. Avoiding payment of contributions for mandatory social insurance reduces the revenues of mandatory social insurance funds, and any shortfall is compensated from the republic budget. Since the collection of contributions has proven to be problematic in the past, the development of the Central Registry of Mandatory Social Insurance is under way and is supposed to ensure reliable collection. If this system were not fully implemented, there is a risk of a new evasion. A collection of contributions that is 1% below the expected increases the general government deficit by 0.2 percentage points.

Collection of non-tax revenues. A portion of non-tax revenues that belong to the Republic budget can be collected in the following period only upon completion of judicial proceedings (revenue from bankruptcy estate of socially-owned enterprises, banks, succession). If these proceedings take a long time and revenues are not collected for some reason or the amount collected is lower, the effect on the deficit increase would be about 0.2 – 0.3 percentage points

Interest. In addition to the level and structure of public debt, interest outlays are affected by factors such as the exchange and interest rates on the international market. Given the unpredictability of certain variables' trends, it is possible that the funds needed for the payment of interest in the following period will be larger. It is estimated that in the worst case, the negative effects could increase the amount of these outlays by 1% of GDP in 2015.

Public-Private Partnership (PPP). A comprehensive risk assessment and analysis at all stages of implementation of public-private partnerships, multiple-year long budgeting for these projects, precise timing of all future costs to the public sector, analysis of commitments and risks for their activation are the preconditions for lessening exposure of public finances to the risks incurred during the implementation of such projects. In addition, amendments to the relevant laws need to provide the Ministry of Finance and Economy with possibility to stop or suspend a project in the preparation and negotiation phases, until potential risks are mitigated or measures undertaken for their mitigation.

1.5. Cyclically Adjusted Fiscal Balance

Cyclically adjusted fiscal balance is the fiscal balance from which the isolated impact of an economic cycle is excluded and which allows the budget position to be considered and the necessary level of fiscal adjustment during the period to be determined, with a possibility to identify more easily the improvements resulting from implementation of fiscal policy measures, as opposed to those resulting from the economic cycle as such.

The OECD disaggregated approach was used to assess the cyclically adjusted deficit, which involves assessment of elasticity of individual categories of cyclically sensitive revenues and expenditures. Cyclically adjusted balance is computed according to the following formula:

$$CABt = B\,t - \eta(Yt - Yt^*)/Yt^*$$

In the above formula, $\eta(Y_t - Y_t^*)/Y_t^*$ is the cyclical part of the balance expressed as the product of the balance sensitivity coefficient relative to output gap (η) and the assessed output gap in the year under review $((Y_t - Y_t^*)/Y_t^*)$. The fiscal balance sensitivity coefficient is equal to the difference of sensitivity coefficients of revenues and expenditures $\eta = \eta_T - \eta_G$.

The final assessed sensitivity coefficients for public revenues and expenditures are $\eta_T=0.386$ and $\eta_G=-0.01$ respectively. The overall fiscal balance sensitivity obtained as a sum of revenue and expenditure sensitivities is $\eta = 0.386 - (-0.01) = 0.387$[3].

[3] A detailed methodological explanation of the elasticity coefficient assessment process and econometric results are shown in the adopted Fiscal Strategy for 2013 with Projectons for 2014 and 2015

Table 12. Fiscal Balance and Components for the Computation of Cyclically Adjusted Balance in the Period 2001-2020, in % of GDP

	Output gap (Cobb-Douglas function)	Fiscal balance*	Cyclically adjusted fiscal balance	Cyclical fiscal balance	Character of fiscal policy (fiscal impulse)
2001	-0.4	-0.7	-0.6	-0.2	/
2002	-0.8	-2.7	-2.4	-0.3	1.8
2003	-3.3	-4.2	-2.9	-1.3	0.5
2004	0.2	-0.9	-1.0	0.1	-1.9
2005	0.1	1.1	1.0	0.0	-2.0
2006	-0.9	-1.6	-1.3	-0.4	2.3
2007	1.8	-2.0	-2.7	0.7	1.4
2008	1.6	-2.6	-3.3	0.6	0.6
2009	-2.9	-4.5	-3.3	-1.1	0.1
2010	-1.6	-4.7	-4.1	-0.6	0.8
2011	-0.1	-5.0	-4.9	0.0	0.8
2012*	-2.3	-6.1	-5.3	-0.9	0.4
2013*	-1.8	-3.6	-2.9	-0.7	-2.4
2014*	-0.9	-1.9	-1.6	-0.3	-1.3
2015*	0.2	-1.0	-1.1	0.1	-0.5
2016*	0.5	0.0	-0.2	0.2	-0.9
2017*	0.8	0.4	0.2	0.3	-0.3
2018*	0.8	0.8	0.5	0.3	-0.3
2019*	0.8	1.0	0.7	0.3	-0.2
2020*	0.9	1.1	0.8	0.3	-0.1

* Projected values are shown for the period 2012-2020

When observing several most recent years, the positive cycle effect is visible in 2007 and in 2008 where positive output gap is present. The effect of the cycle is such that it results in a balance that is lower than it would be were the economy on the path of potential growth. Conversely, when the crisis was at its peak in 2009 and 2010 the impact of the cycle is negative, the output gap reaches high negative values, and actual fiscal balance reaches a deficit considerably higher than the cyclically adjusted one. In the period between 2012 and 2014, GDP growth rates come closer to the potential; the output gap is close to zero and achieves a positive value in 2015. The cyclically adjusted deficit trend is also used as an indicator of the fiscal policy character. In the Table above, the last column shows the fiscal impulse obtained as a difference between the cyclically adjusted deficit in the current and preceding year. 4

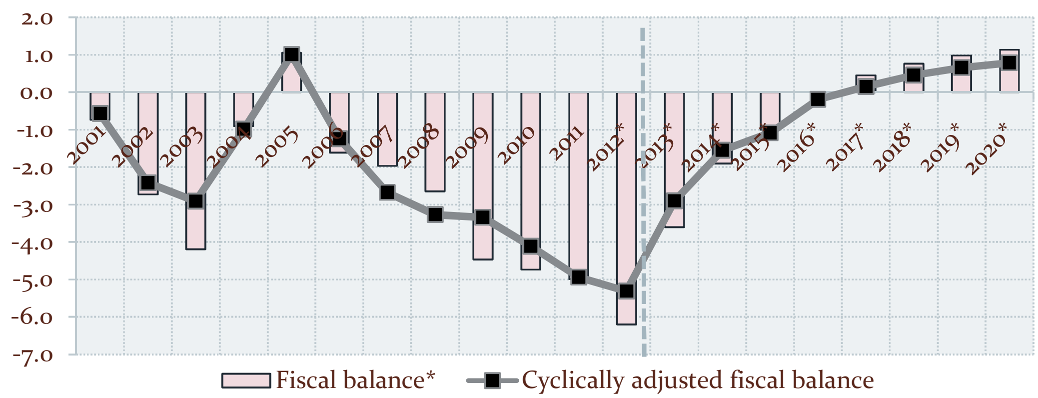
When the output gap is also included in the analysis, the effects of fiscal policy can be evaluated in terms of its pro-cyclicality or counter-cyclicality. The period of counter-cyclical policy was present in 2009 and throughout the crisis, because a relatively expansive fiscal policy was pursued in the circumstances of below-potential growth. Economic logic, at first glance, imposes such behaviour whether it be a conscious one or a consequence of the structure of tax and public expenditure system. As a consequence of the expansive policy the result of which is not the acceleration of growth, and fiscal policy measures alone cannot eliminate the fundamental reasons for the existence of a negative output gap and growth (decline) which is far below the potential, both actual and cyclically adjusted balance deepen, and public debt enters the phase of expansion.

[4] It would be methodologically correct to include the cyclically adjusted primary balance into the analysis as a measure of fiscal impulse; however, an objective picture of the fiscal policy character and impact can also be obtained in this manner. There are, of course, various limitations to using the cyclically adjusted deficit for evaluating fiscal policy effects in this sense, so one should be cautious when making a definitive evaluation.

The measures for fiscal consolidation and public debt reduction explained in the previous chapters are primarily aimed at reducing the cyclically adjusted fiscal balance, as in this way the structure of the tax system changes permanently, as does the capacity of the expenditure system. After 2015, we enter the above-potential growth zone and a positive output gap emerges. A combination of the continuation of a restrictive fiscal policy and a balanced fiscal policy in subsequent periods leads to a desirable form of counter-cyclical fiscal policy.

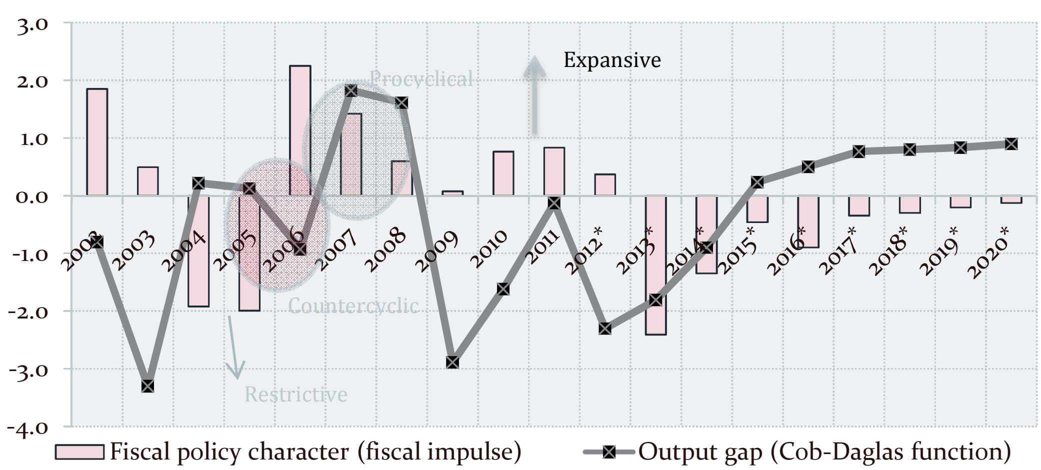
In the context of the public debt reduction programme, and when the character of fiscal policy is included in the analysis, it is noticeable that the level of fiscal adjustment (restrictiveness) decreases gradually in the period 2013 - 2015. This is partly due to the acceleration of real growth and reduction of output gap in the period under review, and partly to the effects of the extended impact of the measures on the revenue and expenditure side. In 2016, negative fiscal impulse will increase for a short while, which indicates that in this period additional measures are needed on the revenue or expenditure side as growth and a positive output gap are not as such sufficient to bring the real fiscal result to the desired level. Thereafter, in the period 2017 - 2020, in the circumstances of an extended period of accelerated growth, the degree of restrictiveness is down again.

Figure 10. Actual and Cyclically-Adjusted Fiscal Balance in the Period 2001-2020, in % of GDP



* Projected values are shown for the period 2013-2020

Figure 11. The Character and Effects of Fiscal Policy in the Period 2002-2020



1.6. Public Debt Management

The Public Debt Management Strategy of the Republic of Serbia sets out the following general goals and principles:

- The financing of the Republic of Serbia fiscal deficit needs to be ensured, in terms of short-term deficit (liquidity) and long-term deficit, as part of the policy for maintaining the public finance system stability;
- The acceptable level of risk needs to be specified, and it needs to be determined within the conditions of a target debt portfolio structure in terms of currency structure of the debt, interest rate structure, maturity structure as well as the structure of debt by instrument;
- The development of market of government securities issued on both domestic and international markets needs to be supported, so that a developed market facilitates a reduction of borrowing costs in the medium and long term, in line with high-quality debt portfolio diversification;
- Transparency and predictability of the borrowing process need to be provided.

According to national methodology, public debt stock includes direct obligations of the central government, as well as all indirect liabilities or the debt guaranteed in favor of public enterprises, some local governments, government agencies and other legal entities the founder of which is the Republic of Serbia. Such stock includes all guarantees irrespective of whether they will be activated in the next period or not.

At the end of October 2012, the total stock of public debt amounted to RSD 1.936,0 billion, or 59.2% of GDP. Of that, direct liabilities accounted for RSD 1.608,6 billion, indirect liabilities accounted for RSD 271.0 billion, while the non-guaranteed debt of local government units accounted for RSD 56.4 billion. Broken down into internal and external public debt, it amounts to RSD 801.1 billion and RSD 1,134.9 billion, respectively.

According to the data as at 31 October 2012, the major portion of the public debt of the Republic of Serbia is still denominated in foreign currencies (i.e. in Euros and the U.S. dollars), while 18.9% of the public debt is denominated in Serbian Dinars. The major part of the public debt of the Republic of Serbia, i.e. 70.6% of it, is subject to fixed interest rate, while 29.4% of total public debt is subject to the variable interest rate.

Taking into account the projected primary budget deficit of the Republic of Serbia for the period 2012-2015, including the volume of loans drawn down for project financing of budget beneficiaries and the effects of changes in Dinar/Euro and Dinar/US Dollar exchange rate, together with the plan to secure the largest portion of financing needs in the future through the issuance of securities, the stock of the Republic of Serbia public debt, excluding guaranteed liabilities (except for *Serbian Railways* and *Roads of Serbia*), and including the local government debt, should be about 56% of GDP by 2015, according to the baseline scenario.

Table 13. Baseline Projection of the stock of General Government Public Debt until 2015

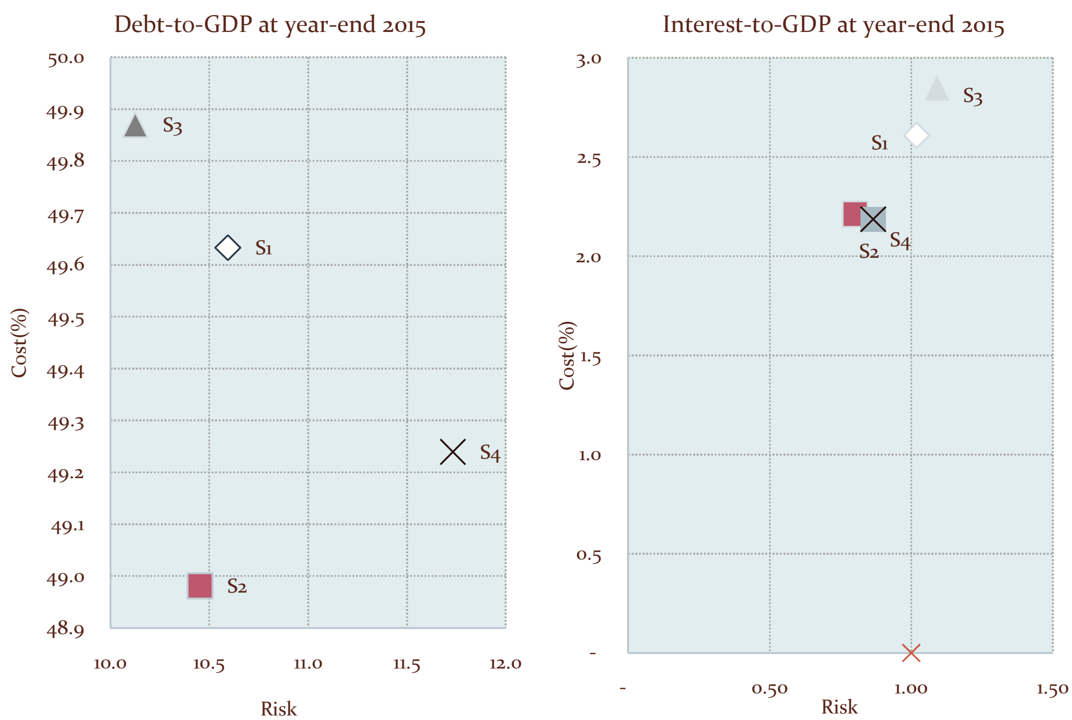
	2012p	2013 p	2014 p	2015 p
		in RSD billion		
GDP	3,267.10	3,679.00	3,979.10	4,316.20
Primary deficit	-133.7	-39.9	24.8	50.9
Interest	69.3	95.7	104.7	97.4
Public debt	2,064.80	2,314.10	2,228.30	2,391.20
Non-guaranteed local government debt	*62.6*	*84.2*	*107*	*128.9*
Debt-to-GDP, in %	63.2	62.9	56.0	55.4
Local government debt to GDP,%	*1.9*	*2.3*	*2.7*	*3.0*

It is envisaged that the local government debt remains relatively at the same level of 2% to 3% of GDP. Debt arising from guaranteed liabilities, which are not included in the public debt balance under the Maastricht Criteria will, in the following period, amount to 4% - 6% of GDP.

Under the 2013 Budget Law, a much lower level of new guarantees is planned than in the previous period. These guarantees will be issued on the basis of planned infrastructure projects, aimed to support the export-oriented economic growth model.

For the purpose of portfolio optimization and more efficient public debt management, a cost and risk analysis of alternative borrowing strategies was performed applying the World Bank model (Medium Term Debt Strategy Model - MTDS). Using the MTDS model, a baseline scenario and three alternative scenarios were analyzed (four analyzed strategies), also taking into consideration the shocks on the side of interest rates and foreign exchange rates (sensitivity analysis).

- The Baseline Strategy (S1): a strategy that covers the financing needs by relying mostly on the existing financial debt instruments. The majority of new borrowing is based on the issuance of government securities denominated in local and foreign currency on the domestic market and the issuance of Eurobonds denominated in U.S. Dollars.
- Strategy (S2): as opposed to S1 strategy, Eurobonds are issued in euro with a five year maturity.
- The Supplementary Dinarisation Strategy with extended maturities (S3): is the strategy relying on increased issuance of dinar-denominated government securities (ranging from 58% to 73% of the gross financing needs by 2015), while maintaining the existing block of standardised RSD instruments with a higher share of long-term instruments.
- The strategy of financing by Eurobond issue (S4): a strategy that fully covers financing needs in the period 2013-2015, by a Eurobond issue denominated in U.S. Dollars with no borrowing on the domestic market and in the local currency.



Financial and fiscal risks can result in a public debt increase above the baseline scenario. Risks that are present and that can lead to an increase in indebtedness and in public debt servicing costs are the following:

1) Refinancing risks,
2) Foreign exchange risk,

3) Market risk (interest rate risk, inflation risk),
4) Liquidity risk,
5) Credit risks,
6) Operational risks,
7) Risks linked to the distribution of debt servicing costs (debt structure, concentration of liabilities).

The main risks for the Strategy implementation, apart from the above listed quantified factors, also include: stability of the macro-economic situation in the Republic of Serbia (real GDP growth, tax collection, unemployment level, inflation, dinar exchange rate against the euro, etc.); development of global economy and of major foreign trade partners of the Republic of Serbia; needs for additional borrowing in order to discharge the debts at other government levels, the public sector and the financial system of Serbia; tax and non-tax revenues below plan and expenditures above plan in the course of a budget year; significant depreciation of the dinar against the euro (above 10%); higher level of local government borrowing than planned in the mid-term macroeconomic (fiscal) framework; activation of issued guarantees.

Table 14. Public Debt-to-GDP Ratio, as at End of 2015

Scenarios	S1	S 2	S 3	S 4
Baseline Scenario	49.6	49.0	49.9	49.2
Exchange rate shock (25% all currencies)	60.2	59.4	60.0	61.0
Interest rate shock (Scenario 1)	50.9	50.1	51.3	50.2
Interest rate shock (Scenario 2)	50.7	49.7	51.0	50.1
Combined shock (25% USD and interest rate shock 1)	54.3	52.5	54.3	54.8
Maximum risk	10.6	10.5	10.1	11.7

Table 15. Interest to GDP Ratio as at End of 2015

Scenarios	S1	S 2	S 3	S 4
Baseline Scenario	2.6	2.2	2.8	2.2
Exchange rate shock (25% all currencies)	3.0	2.6	3.3	2.6
Interest rate shock (Scenario 1)	3.4	2.9	3.7	2.7
Interest rate shock (Scenario 2)	3.2	2.7	3.5	2.7
Combined shock(25%USD and interest rate shock 1)	3.6	3.0	3.9	3.1
Maximum risk	1.0	0.8	1.1	0.9

Table 16. Risk Indicators for Alternative Strategies

Risk indicators		As at end of 2015			
		S1	S 2	S 3	S 4
Nominal debt (% of GDP)		49.6	49.0	49.9	49.2
Net present value (% of GDP)		46.1	45.5	46.4	45.9
Applied interest rate (%)		5.2	4.5	5.7	4.4
Refinancing risk	ATM[5] external portfolio (in years)	8.5	8.4	8.5	8.3
	ATM domestic portfolio (in years)	1.2	1.2	1.1	1.8
	ATM total portfolio (in years)	7.9	7.9	7.8	8.2
Interest rate risk	ATR[6] (in years)	4.8	4.8	4.7	4.9
	Refixing (% of total debt)	32.9	32.9	34.7	26.4
	Debt at fixed rates (% of total debt)	73.2	73.2	71.4	79.3
Foreign exchange risk	Debt denominated in foreign currencies (% of total debt)	86.8	87.1	76.3	98.6

In view of the above listed limitations and potential risks, the objective of the Public Debt Management Strategy in the following long- and medium-term period is financing of the Republic of Serbia Budget outlays mainly through issues of government securities in international and domestic capital markets. Even though the development and “dinarisation” of the domestic market

[5] ATM (*Average Time to Maturity*)
[6] ATR (*Average Time to Refixing*)

is identified as one of the main objectives of the Strategy, due to the current market situation, a large portion of financing over the following medium-term period will be provided in the international financial market. Public debt management policy must take into account the long-term prospects, but the decision on financing budget outlays must be made on an annual basis. The decision on annual borrowing is made within the framework of the Budget Law for the given fiscal year and in accordance with the changes in basic fiscal aggregates, it is possible to change the borrowing plan in the course of the fiscal year.

Development of the domestic market will be supported by the Republic of Serbia. If the planned activities related to the issue of dinar-denominated securities with longer maturities are realized, the yield curve for dinars would be determined by the end of 2014. In the medium-term period, the improvement of secondary market for government securities is also envisaged, which would, together with a transparent dinar yield curve, result in the improvement of the diner-denominated portion of financial market, thus enabling the Government of the Republic of Serbia to finance its outlays more efficiently with lower exposure to foreign exchange and other risks. The plan for extension of maturities of dinar-denominated securities depends on numerous factors, but predominantly how successful the National Bank of Serbia is in the process of dinarisation and maintaining the inflation within the set target range, as well as on growing confidence in the monetary and economic policy of the National Bank and the Republic of Serbia Government.

IV. The Objectives Of Structural Reforms in the Period 2013 -2015

1. Obstacles to Growth and Structural Reform Plan

Structural reforms to be implemented by the Government in the following medium-term period play a vital role in the establishment macroeconomic stability, acceleration of economic growth and the increase of investment and employment, as well as in the establishment of a sustainable balance of public finance.

The objective of the structural reform acceleration is to create an enabling economic environment for economic and investment activity and strengthen the private sector that generates sustainable economic development. In the past transition period, economic growth has been primarily based on consumption growth, derived from privatization proceeds and heavy borrowing abroad, primarily by the private sector, while the contribution of reforms implemented has been insufficient.

In the following period, it is essential that the economic growth should be predominantly based on the increase of investments and exports. Such concept of growth involves consistent implementation of comprehensive reforms whose task is to ensure full protection of property and contract, efficient judiciary, a modern tax system, reformed public sector, an efficient banking system and development of financial markets, flexible labour market with clearly regulated rights and obligations of both employers and employees, as well as progress in reducing the shadow economy and corruption. All of this put together increases the credibility of the country and reduces the risk for investment in development.

The economic crisis has exposed structural weaknesses of the economy and obstacles to a sustainable economic development of the country. The greatest structural obstacles to economic growth are: excessive state influence on the economy due to slowed down restructuring and privatization of the remaining state-owned and public enterprises, administrative barriers and regulatory limitations to business which increase the costs of the economy and at the same time reduce legal certainty, the lack of competition in certain sectors, lack of infrastructure, structural inflexibility of the labour market and a significant share of informal economy.

For the purpose of strengthening the entrepreneurship sector, a better business and investment climate will be provided for to reduce the costs and risks of doing business and investing in Serbia, as well as the completion of the restructuring process in state-owned enterprises and acceleration of the establishment of new private enterprises. In addition, better protection of competition, support to faster development of small and medium-sized enterprises and entrepreneurship, elimination of inflexible labour market conditions and more efficient bankruptcy proceedings will also be ensured. Special attention will be paid to structural reforms fostering capacity building of the economy to increase production, savings, exports and employment, which, in turn, will result in cost reduction for businesses.

In order to strengthen the private sector, restructuring and privatization of the remaining state-owned enterprises in the portfolio of the Privatization Agency will be accelerated and completed within the legally established deadline, based on the analysis and evaluation of economic sustainability. Furthermore, restructuring and privatization of public enterprises will also be accelerated to improve their management and increase their efficiency, followed by privatisation of some of those companies by attracting strategic investors.

Structural reforms of large segments of public spending such as public finance management, the pension system, education, health care, social security, reform of state-owned and public enterprises which exert a large burden on the public finances, reform of the subsidies system as well as the reform of local public finance, will significantly contribute to the long-term sustainability of fiscal policy.

Implementation of public sector reforms in the medium term aims to reduce the role of the public sector in the economy and increase its efficiency in pursuing the overarching interests of the society. This provide for a higher degree of fiscal adjustment, primarily on the expenditure side, through lower deficits and decrease in borrowing needs.

Removal of these and other structural obstacles for economic growth requires the implementation of an active structural policy. Any delay in thorough preparation and implementation of structural reforms would present a great risk to the achievement of economic and fiscal policy objectives, particularly the reduction of fiscal deficit and prevention of public debt crisis.

The planned fiscal adjustment over the following three fiscal years cannot be achieved by measures of tax and fiscal policy only, without implementation of reforms. Therefore, it is necessary to that the competent republic ministries, starting from the established Fiscal Strategy for the following medium-term period, prepare in the course of 2013, the relevant legal acts by which the Structural Reforms Plan contained in the Fiscal Strategy of the Government will be implemented over the next three fiscal years. An overview of the planned structural measures and key policies aimed at removing structural obstacles to growth is presented in the Section 1.1. of this Chapter of PEP.

1.1. The Main Areas of Structural Reforms

1.1.1. Structural Reforms in the Real Sector

The Reforms Improving the Business Environment

Sustainable economic development of the Republic of Serbia involves constant improvement of the investment and business climate. In the past transitional period, Serbia has been improving the business environment by implementing legal and institutional reforms to increase legal certainty for doing business and investing in the country.

Improvement of the business environment through reduction of costs and risks of doing business is vital for encouraging investment and employment in Serbia. Subsidies are just an additional incentive mechanism that cannot compensate for system weaknesses and poor business environment.

The aim is to reduce the regulatory burden which is a major obstacle to faster development of the private sector. In this regard, it is important to establish a system that will enable and oblige all government authorities to access data maintained in the records and registries of other government authorities, so that both citizens and companies would no longer have to support each submitted application with numerous statements and certificates. In this respect, the implementation of the "guillotine of regulations" project will be completed, and the analysis regulatory impact of draft laws and other regulations on the business environment for the private sector improved. Through the "regulatory guillotine", the Government and relevant ministries will eliminate all administrative barriers which, in the form of complex, non-transparent and unnecessary bureaucratic procedures increase the cost of doing business

The most significant effects on the improvement of business environment is achieved by the simplification of administrative procedures by abolishing the obligation of payment of daily receipts into the account each day, extension of validity of travel orders up to 30 days, the submission of annual financial reports to the Business Registers Agency only, establishment of the one-stop shop system for registering and deregistering of employees for compulsory social insurance. The business environment is further improved by separating the issuance of the tax identification number from the tax liability audit, standardization and electronic filing of tax returns, the abolishment of mandatory audit for start-ups in the year of establishment, allocation of taxes and contributions on wages, etc.

By eliminating 138 parafiscal charges that were a burden to businesses and citizens, significant progress was made towards reducing costs of doing business for more than 300,000 sole proprietors and small business owners. A new Law on Fees for Public Goods Utilization will be enacted, consolidating all charges payable for the use of natural resources and the resources of common interest, and consequently, significantly improve transparency of the public revenue system and ensure the predictability of operating costs for the businesses.

The Government and relevant authorities will create preconditions for the fight against systemic corruption as a serious obstacle to investment and doing business in Serbia. A high degree of corruption at the state and local levels adversely affects the business environment and distorts fair competition which is essential for economic growth.

The Government and competent ministries will ensure that the state of infrastructure in the Republic of Serbia is improved. The construction of modern transport, telecommunications, and energy infrastructure will significantly contribute to reduced transport costs for passengers and goods, costs of information transfer, as well as costs of power, gas and other energy supply.

Improvements in the competition policy will significantly contribute to a better business environment and the efficient operation of the market of goods, which is an important requirement for sustainable economic growth in the long term. To this end, it is necessary to increase the professional capacity of the Commission for Protection of Competition and ensure efficient implementation of the legal framework for competition policy.

A conducive business environment implies the existence of financial discipline, where all participants in the market discharge their liabilities in accordance with the contract and the law. Lack of financial discipline causes an increase in the number of insolvent businesses which fail to fulfil their obligations in accordance with commercial standards. Establishment of financial discipline requires the elimination of insolvent entities from the market through efficient implementation of bankruptcy legislation.

For the purpose of strengthening financial discipline, the Law on the Terms of Settling Cash Liabilities in Commercial Transactions was passed. In order to improve the business environment and prevent failure of timely settlement of cash liabilities between the public sector and businesses, the Law stipulates that the contract between the public sector and businesses cannot provide for the settlement of cash liabilities within the period exceeding 45 days, when according to such contract, the debtor is a public sector entity. Exceptionally, a longer period for settlement of cash liabilities is envisaged when the debtor is the Health Insurance Fund of the Republic of Serbia. The term for settlement of cash liabilities may not exceed 60 days if the contractual debtor is a business. This will ensure the regularity of payments and greater liquidity but also prevent the creation of new arrears.

Efficient functioning of the market economy requires that clearly defined property rights are implemented to reduce business risks and attract strategic investors. In the framework of structural reforms, legal and institutional preconditions have been established for dealing with and guaranteeing property rights in the Republic of Serbia through the amendments to the Law on Planning and Construction and the adoption of the Law on Public Property as well as the Law on Property Restitution and Compensation, the implementation of which is vital for relieving the uncertainty of investments by private investors.

Starting from the constraints for businesses, regulatory and administrative reforms need to be focused on areas in which Serbia is lagging the most (faster and cheaper issuance of building permits, simplification of tax payment, faster registration of property, contract enforcement, reform and modernization of inspection services according to EU standards and improvement of national quality infrastructure).

Reforms Improving the Land Policy

Improving land policy is of particular importance for the investment activity in the country. Basic directions for improving land policy are:

- increase of property rights security;
- better land management through simplification and shortening of the procedure for permit issuance, legalization of facilities and settlements and consolidation of agricultural land which, according to EU standards, is fragmented in Serbia, thus increasing the production costs and discouraging investors;
- capacity and system building for management of state land, training of land administration at the national and local levels, better appraisal of land value and increased transparency in the land management sector.

Special attention will be paid to simplification of procedures for easier and cheaper obtaining of building permits, more efficient implementation of the established cadastre of land and other real property including the state-owned real property, as well as to the establishment of a national land management programme for the purpose of aggregation of fragmented agricultural land.

By adoption of the Law on Planning and Construction in 2009, and its amendments in April 2011, the Law on State Survey and Cadastre, the Mortgage Law, the Law on Financial Leasing as well as the Social Housing Law, a new legal and institutional framework for the promotion of the real estate market was established.

A key problem in the implementation of the Law on Planning and Construction is slow and complicated process of issuing building permits. The process of obtaining permits remained non-transparent, long-lasting and burdened with bureaucratic procedures, often creating grounds for corruption, primarily as a consequence of the requirement to obtain numerous documents required for submission of applications. Therefore, a new Law on Planning and Construction will be enacted to simplify and shorten the process of obtaining building permits, resolve the problem with the lack of planning documents, and reduce the number of institutions to which applications need to be submitted, as well as to provide a “one-stop shop” system for investors. In addition, this law will introduce an obligation for the government authorities and public utility enterprises to share among themselves the necessary documents, and it will also specify the conditions for obtaining building permits and prevent the imposition of additional conditions by other regulations.

A higher inflow of investments also requires appropriate amendments to the Law on Obligations and the rulebooks regulating the construction process to improve the investor-contractor relationship. The amendments to the Law on Value Added Tax envisage that, as of January 2013, the investor shall pay VAT and not the contractor as was the case before.

Efficient implementation of the established uniform land registration cadastral system by the cadastral municipalities is of particular importance for the improvement of land policy, to resolve many irregularities in the process of acquiring property rights related to incomplete land registries and other land information. The objective is to have all cadastral municipalities introduce the system of "all information in one place" for investors.

The Mortgage Law that introduced the possibility of re-issuance of a building permit in the process of mortgage enforcement over semi-completed structures to the name of the person buying the building requires harmonization with the Law on Planning and Construction, and clarifications as to whether the mortgage is automatically extended to the buildings built on the mortgaged land.

Further simplification and acceleration of the procedure for land expropriation is necessary for the purpose of implementation of infrastructure projects. The existing system partially removed obstacles to expropriation; however, it is still inefficient due to long deadlines, numerous procedural steps, and mild sanctions for non-compliance. This is an important reason for inefficient implementation of numerous projects, from European road corridors to local electricity transmission lines.

Reforms Strengthening Export Potential

Fast and sustainable export-oriented economic growth requires adjustment of the economy through successful structural reforms and improved competitiveness, which in turn reduces the current account deficit, and trade deficit in particular. The return to higher and high economic growth rates requires much higher productivity, competitiveness and export, which involves the elimination of administrative barriers for domestic and foreign investors and the increase of competitiveness in principal economic sectors through sectoral reforms.

The key activities of the state in the area of competitiveness improvement and export of tradable goods include fostering investments in metal, automotive, electronic, defence and food processing industries, as the main export sectors, as well as the increase of investment in agriculture.

The Government will pursue a predictable and stimulating industrial policy. Within the framework of its significant potential for the increase of production and exports, typical export-oriented products are produced in Serbia (vegetables and fruits, cereals, clothing, iron and metals, sugar and paper), as well as new export products (products of iron and metal, non-ferrous metals, rubber products, industrial metal products, various industrial products and artificial resins and plastic materials). The production of sophisticated products for export (machinery, automobiles, electronic products, and pharmaceuticals) is also increasing. Such products are more difficult to produce, but they are more profitable. The production of less sophisticated products for export, such as raw materials, is significant as well. Export of services is becoming increasingly important, especially of services in the information technology sector, e-commerce and e-business. This contributes to greater diversification of export, thus generating more foreign exchange revenues from export, especially from products of high added value. In this respect, it is necessary to support export of products from automotive, metal, electronic, food processing and defence industries, these being the sectors with competitive advantages. On the other hand, there is significant support provided for the export of services, particularly in the field of information technology. The increase of export depends to a great extent on elimination of barriers in export-oriented sectors to boost their competitiveness and productivity. Utilization of information and communication technologies in all sectors of the economy also contributes significantly to improving competitiveness and easier inclusion in the global supply chains.

The Government will pursue a predictable and stimulating agricultural policy aimed at effectuating potentials in all sectors of agriculture, and thus significantly increasing the productivity, competitiveness and export of agricultural products. Serbia has a huge potential for the boosting agriculture and could become a significant European net exporter of food. The performance in agriculture is far below the development potential, owing to unpredictable agricultural policy, without clear and reliable signals for participants in the agricultural market chain. In the coming years, the state will have to provide greater support to the growth of production, productivity, competitiveness, and export of agricultural products by increasing the agricultural budget and promoting investments in agriculture to increase its competitiveness on the world market.

The main goals and directions of agricultural policy are the following: accelerated restructuring of the agricultural sector according to EU standards and increased investments in development of agricultural infrastructure; development of effective advisory services and changes in the farmers' behaviour; improvements in the supply chains that prevent market distortions coupled with increased investments for such purposes; further trade liberalization by decreasing tariff protection in order to direct farmers towards export-oriented production without applying *ad* *hoc* trade prohibition, the system of permits or non-tariff barriers, with the possibility of abolishment of export subsidies.

1.1.2. Reforms Improving the Labour Market

High unemployment and insufficient education quality call for an improvement in labour and employment regulations, as well as an improvement in the education system and its adjustment to the labour market requirements.

Improving the labour market and raising the labour quality through education and training will significantly contribute to the economic and social development of the Republic of Serbia. In that respect the implementation of the National Employment Strategy for 2011-2020 and the Strategy for Education Development in the Republic of Serbia until 2020 have special significance in terms of development.

The situation in the labour market is unfavourable according to the Labour Force Survey (LFS) data, as well as according to the statistical survey on employed persons and their wages (RAD-1). Formal employment figures have been falling continuously since 2009. According to the Labour Force Survey from October 2012, the unemployment rate and the employment rate are 22.4% and 36.7%, respectively.

A reduction of high unemployment implies an economic policy focused on growth and employment, as well as raising labour market flexibility and mobility through reforms ensuring a reduction of rigidity in hiring and firing and of costs of laying off workers. This also entails an implementation of active labour market policies which ensure the matching of labour supply and demand and labour force capacity building by increasing the level of its knowledge and skills that are in line with labour market requirements.

Additional education and training programmes for unemployed persons play a special role, as they increase their competences in line with employer requirements in the labour market. Professional rehabilitation measures that increase the employability of persons with disability are also important. It is necessary to prepare a national qualifications framework and a national job classification system according to international standards. The main instrument for implementing active employment policy are annual employment action plans with defined goals, priorities, programmes, measures and tools intended for active job seeking, additional education and training programmes, employment subsidies and public works.

Reform of the labour market legislative framework is of key importance for stimulating new job creation in the private sector. To that end, during 2013 labour and employment regulations will be improved in four main directions:

- elimination of barriers to hiring and firing (duration of fixed-term employment contracts, secondment, rescheduling of working hours)
- change of structure and calculation of wages and severance pay (annual leave, severance pay)
- collective bargaining reform (extended effect of collective bargaining agreements, representativeness of participants in socio-economic dialogue)
- simplification of rules hindering hiring and business operation.

One of the methods for increasing employment is to improve the legal framework for the self-employed (freelancers and independent contractors) and stimulate self-employment.

By amending the Law on Aliens the procedure for obtaining business visas and residence permits should be simplified. Furthermore, a separate law or the Labour Law should ensure the protection of workers from the Republic of Serbia working abroad.

Particularly important for the marker functioning is the reduction of labour costs in order to increase the employment rate and reduce unofficial labour.

1.1.3. Structural Public Sector Reforms

Reforms Improving Public Finance Management

Within the public finance management system, the introduced amendments to the Budget System Law, providing that the own revenue of budget beneficiaries becomes the general budget revenue, are of particular importance and ensure more efficient spending of these funds through more realistic planning and greater control. At the same time, the Law Amending the Law on the 2012 Budget of the Republic of Serbia and the Bill on the 2013 Budget of the Republic of Serbia prescribe that all revenue and receipts, as well as expenditure and outlays are to be presented in gross amount, i.e. by all financing sources. This method of fiscal result presentation reflects the true fiscal position of the republic budget. With the amendments to the Budget System Law all the revenue and expenditure of budget beneficiaries and extrabudgetary funds are integrated in the budget process, which will enable better liquidity management through the Single Treasury Account via an integrated financial management information system encompassing all general government participants, including institutions that are not budget beneficiaries.

As part of the public finance management reform the preparation of the medium term expenditure framework will be improved through interdepartmental fiscal coordination, programme budgeting will be introduced and capital budgeting process improved. The limits for total expenditure of the republic budget for the following three fiscal years will be determined starting from the planned fiscal deficit and estimated effects of structural reforms. Special attention will be paid to the improvement of interdepartmental fiscal coordination among the direct beneficiaries of the republic budget, especially in determining priority areas for financing in the following three fiscal years as the basis for defining medium-term economic and fiscal policy. The introduction of programme budgeting is of major importance for the improvement of public finance, as it enables continuous multi-year financing of priority policies, programmes and projects (infrastructure policies and programmes, export oriented policies and programmes etc.), whose implementation requires longer periods of time. The Law on the 2013 Budget of the Republic of Serbia introduced for the first time three-year capital investment budgeting, which will ensure better development project planning. In the following period comprehensive preparation of institutions for the introduction of programme budgeting will be conducted, as it is planned for the 2015 budget year according to the Budget System Law.

A significant structural measure with a large fiscal effect is the abolishment of unnecessary republic and local parafiscal charges. By adopting 24 laws aimed at fiscal consolidation, at the end of September 2012, 138 parafiscal charges were abolished, as well as 7 agencies, funds and regulatory bodies. The fees collected by various republic agencies and commissions as own revenue have been abolished or reduced to a level that is in line with the real capacity of the economy. The introduction and manner of determining the level of all remaining fees for the use of natural resources and resources of public interest will be regulated by the Law on Fees for the Use of Public Resources, providing for greater predictability of business operation and optimum use of public resources. This will prevent inconsistent and non-transparent determination and collection of numerous fees for the use of public resources which was often at odds with their purpose and function, so some fees were too high and presented a burden on the economy, while others were low and conducive to irrational consumption of natural and public resources.

Among the fiscal consolidation measures, there is an important structural measure limiting the growth of wages and pensions, in line with budget capacity, as well as the harmonisation of rules for setting wages in the entire public sector, with the maximum monthly public sector wage set in the net amount of RSD 162,740. Apart from that, there are plans for the introduction of a single employee registry, as well as the rationalisation of the existing number of employees in government authorities and public services at the republic, provincial and local level, primarily in the area of education, health care, public agencies and local administration. A reform of the wage and employment system would raise the public sector efficiency and ensure that costs are in line with the capacity and productivity of the Serbian economy, which implies additional measures.

During 2013 a uniform system of pay grades will be introduced, harmonising the levels of wages for similar jobs in different government and public services, since currently employees with the same qualifications and the same job description receive different wages in different parts of the general government. With the amendments to the Law on Wages of Civil Servants and Employees, as well as other regulations governing public sector wages, during 2013 it is necessary to define uniform pay grades, so that those changes could be integrated in the 2014 republic budget.

During 2013 the Programme of General government Employment Rationalisation will be prepared, including local self-government on the basis of analysing surplus labour in certain government and public services. At the same time, the World Bank findings identifying non-medical staff surplus in the health care sector, unjustified increase in administration at the local level in 2006-2008 and surplus labour in primary education due to a decrease in the number of enrolled pupils, in particular in rural areas. There is a need for a medium-term staffing reduction plan for the government administration and public services, whose implementation would lead to significant budget savings and raise the efficiency of the general government and public services. It is estimated that the number of staff in the government administration and public services could be cut by at least 5%[7], primarily in the area of education, health care, local self-government and public agencies. In the medium term such streamlining in the government administration and public services could result in savings of up to around 0.4% of GDP[8] at the annual level.

In the first half of 2013 an integrated central registry of employees in the government and public services will be set up and enable the implementation of a new wage and employment system in the government administration and public services. For that reason, it is necessary to expand the coverage of the existing information system to the employees in the health care, police, military, public agencies for which there are no integrated staff records. This will enable the formation of an adequate data base, monitoring of staff structure in the government and public services and ensure the implementation of legal provisions. With the introduction of the central registry, the precise number of staff in the government and public services will be determined and it will be possible to streamline the expenditure for permanent, temporary and occasional staff, including the technical consultants based on service contracts.

The level of wages in the public enterprise sector at the republic and local level will be aligned with the capacity and productivity of the economy and the level of private sector wages. Special attention will be dedicated to the introduction of stricter financial control of the large state enterprises, including the setting of the mandatory wage bill ceiling in those enterprises. Public enterprises at the republic and local level will adopt staff reduction programmes during 2013, with the aim of increasing cost efficiency as a basic prerequisite for price liberalisation.

A sustainable public finance system implies a competitive and efficient tax system and predictable tax policy. In the following period indirect tax policy is planned to be harmonised gradually with the EU rules. Any tax policy changes involving a reduction of tax burden on wages will be accompanied with an increase in consumption taxes, so that the net effect on total revenue would be neutral. The adoption of a new personal income tax will expand the tax base and reduce differences in the effective tax burden on income from labour depending on the source or contractual basis of income. This will ensure an increase in horizontal and vertical fairness of taxation, as well as actual tax revenues.

Property tax legislation is also slated for improvement by linking the tax base with the market value of properties. The amendments to the Property Tax Law will primarily be aimed at

[7] Fiscal Council’s estimate.
[8] Fiscal Council’s estimate.

changing the method of assessing the tax base for persons keeping books. The existing solution, which is correct in principle, in which the property tax base for these persons is determined as a value in their books, is currently a source of significant tax evasion, since a large number of taxpayers systematically understate this value. It is, thus, necessary to introduce a mandatory independent appraisal of the so-called fair value of these persons' property to be conducted every 3 to 5 years. This amendment is also necessary as a partial revenue compensation for the already legally prescribed abolishment of the construction land use fee, which presents significant revenue for local self-governments, but also a highly discriminatory and discretionary public charge.

The tax administration efficiency in combating the grey economy and tax evasion will be increased in order to improve further the business environment and the conditions for efficient market operation. The goal is for the companies and citizens that generate the same income or have properties of the same value to pay the same tax, ensuring the level playing field for companies and equality of the citizens. It is estimated that in the medium term combating the grey economy and tax evasion could result in significant additional increase in public revenue depending on the volume of transactions in the grey economy in the Republic of Serbia . The key preconditions for that include political and social will to stop the violation of the tax laws and efficient tax administration.

A significant contribution to strengthening financial discipline and increasing public revenue will be given by the Law on Conditional Interest Write-Off and Tax Debt Standstill, which will facilitate the settlement of tax debts that became due up to 31 October 2012 and create conditions for regular settlement of current liabilities. It prescribes that a taxpayer that settles his current liabilities regularly will be granted a conditional write-off of his interest debt, with a standstill of the debt principal lasting for not more than two years. After meeting the requirements for interest write-off, the taxpayer will be able to settle the tax debt principal in 24 monthly instalments, while settling his current liabilities. In such a way, exercising the right under this law is made conditional upon financial discipline in the period of standstill of the tax debt principal, which means that this right can be exercises only by those taxpayers who settle duly all their fiscal obligations on all grounds starting from 1 November 2012 until the end of the standstill period, and who, after the expiry of the standstill period, settle the debt principal within the prescribed time period. In such a way, detrimental consequences for legal persons, entrepreneurs and individuals that would have been caused by forced collection of overdue public revenue are eliminated. Apart from the additionally collected tax revenues, the expected effects of this Law include the impact on overall reinforcement of tax compliance and strong contribution to resolving illiquidity problems in the economy.

Tax procedures will be simplified and unnecessary procedures will be eliminated, in order to facilitate tax payment and ensure adequate taxpayer treatment. To that end there is a need for modernisation and increase in tax administration efficiency. The modernisation of the Tax Administration will be implemented primarily by introducing a new integrated information system which should make it easier to the real sector to discharge its statutory tax liabilities with regard to e-filing of tax returns and also create the IT basis for managing audit and control functions.

For the purpose of improving the operation and enhancing the quality of services provided to the citizens and businesses by the government administration, the Ministry of Justice and Public Administration has been tasked, in cooperation with other ministries, with preparing and adopting, by August 2013, a strategic document on further public administration reform and modernisation, including public agencies, public services and local self-government, as well as an action plan for the implementation of government administration reform in 2013-2016. The goal is to create public administration in line with the European Principles for Public Administration (reliability, predictability, openness, efficiency and effectiveness) and build the government administration capacity as one of the criteria for the EU accession. Appropriate amendments to the law on civil servants and appropriate bylaws will thus be adopted.

A new law on general administrative procedure is to be prepared by the end of August 2013, regulating all administrative activities and not just standard administrative documents. The implementation of this law requires training of employees in the public government authorities and providing information to the citizens who exercise their rights before the competent administration bodies. In accordance with the provisions of this law, the Law on Administrative Disputes will be amended. Appropriate amendments to the Law on Ombudsman are also planned with the aim of more complete and efficient protection of the citizens' rights, as well as amendments to the Law on National Minority Councils. A new law on inspection supervision regulating the competences, manner of operation and organisation of the inspection is slated for adoption.

Reforms of State and Public Enterprises

The Government will accelerate the reforms of state enterprises in order to increase operating efficiency and professionalise public enterprises, while cutting subsidies at the same time. It is estimated that after eleven years of transition in the Republic of Serbia around 1,300 enterprises remain under state control, receiving budget subsidies and thus causing an increase in total expenditure and deficit. The stated enterprises also receive different forms of indirect subsidies such as state loan guarantees, non-payment of taxes and contributions, linking the years of service. Total budget expenditure for supporting these enterprises (state subsidies, transfers for linking the years of service and expenditure for guaranteed debt servicing) in 2011 amounted to around 2.3% of GDP. Total support to state-controlled enterprises (state enterprises in the portfolio of the Agency for Privatisation and state-owned republic and local enterprises) is estimated at around EUR 700 million per year.

Table 17. Estimate of fiscal cost of socially-owned and public enterprises in the Republic of

Cash transfers (2010 and 2011 average)								
	Direct subsidies		**Servicing of debt of public state enterprises**		**Transfers for linking the years of service**		**Total**	
	mil. EUR	in % GDP	mil. EUR	in % GDP	mil. EUR	in % GDP	mil. EUR	in % GDP
Public state enterprises	160	0.5	76	0.3	12	0.1	248	0.9
Socially-owned enterprises in the portfolio of the Agency for Privatisation	94	0.3	0	0.0	172	0.5	266	0.9
Local enterprises	223	0.8	0	0.0	-	0.0	223	0.8
Total	477	1.6	76	0.3	184	0.6	737	2.5
Stock of indirect liabilities (end of 2011)								
	State guarantees		**Arrears towards gov. authorities and institutions**		**Arrears towards public enterprises**		**Total**	
	mil. EUR	in % GDP	mil. EUR	in % GDP	mil. EUR	in % GDP	mil. EUR	in % GDP
Public state enterprises	1,742	5.7	288	0.9	84	0.3	2,113	7.0
Socially-owned enterprises in the portfolio of the Agency for Privatisation	74	0.2	1,100	3.6	441	1.5	1,616	5.3
Local enterprises	-	-	-	-	-	-	-	-
Total	1,816	5.9	1,388	4.6	525	1.7	3,729	12.2

Source: World Bank, *Public Enterprise Restructuring Development Policy Loan*, 2012

By analysing the beneficiaries of direct and indirect subsidies (all types of fiscal costs arising from cash transfers or non-payment of due public revenues) it was determined that most funds are directed towards the group of enterprises undergoing restructuring. Currently, 175 enterprises employing around 55,000 staff (out of 100,000 in the Agency's portfolio) are undergoing restructuring (out of 594 under the jurisdiction of the Agency for Privatisation). These enterprises accumulated in their operation so far loss above equity in the amount of RSD 75 billion (of the total losses of RSD 78 billion), while the loss incurred in 2010 amounting to RSD 37 billion (of the total of 40 billion losses of all the companies in the Agency's portfolio).

The amendments to the Privatisation Law prescribe that state enterprise restructuring is to be competed by 30 June 2014. To that end, an Action Plan for Restructuring Process Completion will be adopted promptly, aiming to end the bulk of restructuring in 2013 depending on the funds for the payment of social programmes. The funds of the Transition Fund are planned to be used exclusively for the enterprises whose final status has been determined and in the context of this strategy implies enterprise privatisation or definitive termination of the restructuring process for the purpose of sustainable operation in market conditions or enterprise bankruptcy.

In the operational sense the remaining enterprises from the Agency's portfolio, including enterprises undergoing restructuring, will be divided into several groups. The first group would consist of enterprises which can be privatised and whose privatisation procedure can be accelerated. The second group consists of enterprises with no economic prospects and for which no buyer can be found. These enterprises have assets and during 2013 the procedure of selling those assets in the market will be initiated. Proceeds from the sale of their assets will be used for social programmes for employees in enterprises undergoing bankruptcy proceedings. The third group consists of enterprises that cannot survive in the market as a whole, but have parts or production programmes that have a chance in the market and, as such, can be privatised, while bankruptcy proceedings will be initiated for the parts with no market prospects. The fourth group are enterprises that have no market prospects as a whole nor do they possess any assets that can be sold in the market. For that group of enterprises, bankruptcy proceedings are to be initiated in the first half of 2013 and their subsidies from the budget should be cut. Funds earmarked for subsidies to these enterprises should be redirected towards social programmes for the workers of those enterprises, together with funds from the Transition Fund. The completion of restructuring of socially-owned enterprises would result in savings from the reduction and elimination of subsidies to these enterprises and certain proceeds from the privatisation of those enterprises that can be privatised and from the sale of assets of those companies that cannot be privatised. On the other hand, potential fiscal costs related to the reform of state enterprises are high, especially payments of severance pay for redundancies in those enterprises and for employees in enterprises that undergo bankruptcy.

During the first half of 2013 efficiency criteria will be defined for state-owned public enterprises, in order to be able to measure their business performance. The increase in efficiency of those enterprises implies reducing direct and indirect subsidies and raising public enterprise services to the economic level. In parallel with the introduction of efficiency criteria, it is necessary to move towards further liberalisation of activities in which public enterprises operate and which are not natural monopolies, which would result in an increase in the economy's efficiency, quality of public services and financial discipline, as well as a decrease in corruption.

The plan is to improve the management of large state enterprises and their operating efficiency and transparency, and then to privatise some of them by attracting strategic investors. In order to improve operating performance, the transformation of all large state enterprises into joint stock companies will be completed and managerial capacities for running state enterprises raised, with strict control of all state enterprises by the Government. To that end, management professionalisation and improvement, corporatisation and introduction of performance evaluation system will be provided in the near future.

The corporatisation of public enterprises will be conducted, transforming them into corporations, with appropriate regulation of their specificities in performing activities of general interest in non-market conditions. Corporatisation will simplify the legal framework and reduce operating costs and risks, facilitating the change of capital structure and form and improving borrowing terms, attracting private investment and ensuring higher efficiency of the government in its role as the owner. This will boost market-based operating rules and improve public service quality in the long run.

The reform of republic and local public enterprises will ensure a reduction of state direct and indirect subsidies through an increase in their efficiency and productivity based on improved management and business operation, technological enhancements, headcount rationalisation and liberalisation of prices of products and services of those companies. Improvement of corporate governance and depolitisation of public enterprises, privatisation of public enterprises able to operate in competitive environment, liberalisation of activities performed by public enterprises that are not natural monopolies (electric power generation, railway transport, certain utilities) and increase in the prices of products and services of public enterprises to the level of justified costs will contribute significantly to the reduction of public spending and fiscal deficit.

Public enterprise management will be professionalised. Independence of public enterprise managements and efficient supervisory role of the Government will be ensured. Remuneration for public enterprise managements will depend on the realisation of plans and achieved results. Constant improvement of knowledge and technologies in public enterprise operation will be ensured. Operating transparency of public enterprises will be ensured through regular publication of annual/semi-annual reports, such as summary reports on public enterprise operation, financial statements, as well as reports on public procurement, aid granted, subsidies and guarantees obtained, on financial risks, transactions with related parties and the like.

Efficient mechanisms for supervising the operation of public enterprises will be put in place. For the purpose of more efficient supervision, rules, contents, methodology and deadlines for the preparation of business plans shall be determined. Rules shall be established and KPIs defined for evaluating business performance of public enterprises and work of public enterprise management at least once a year, as well as a code of conduct for public enterprise managers and employees.

State enterprise restructuring will be based on the improvement of corporate governance and financial management of enterprises which will remain in state hands, improvement of business performance of enterprises and mitigation of consequences of restructuring on staff that will be laid off. This will contribute significantly to the improvement of quality of public enterprise services and reduction of corruption and crime. State and public enterprise reform can ensure medium-term savings in subsidies of around 0.6% of GDP based on the reduction of direct and indirect subsidies to enterprises, reduction of guarantees given and executed, improved tax collection and generation of privatisation proceeds, which will contribute to an increase in economic activity and public sector employment.

Reforms Improving the Subsidy System

Unrestructured and non-privatised enterprises under state control reduce the performance of the economy and foster lack of financial discipline and corruption. For that reason it is necessary to accelerate their restructuring and privatisation, which will contribute to the reduction of total expenditure for subsidies. Potential savings in total subsidy expenditure that could be generated in the medium term are estimated at around 1.7% of GDP[9].

State and public enterprise reform will accompanied by subsidy restriction, with a change in the structure and mechanisms of subsidy granting. In that respect, the most significant changes in the subsidy system include the elimination of direct and indirect subsidies to state enterprises from 2015. In the following three-year period subsidies to AD Železnice Srbije (JSC Railroads of Serbia) are to drop to 0.5% of GDP a year, while for JP PEU Resavica (Resavica Public Enterprise for Underground Coal Extraction) a strategic partner is to be sought pending privatisation, i.e. until complete termination of subsidies to this enterprise from 2015. At the level of local self-governments a reduction of subsidies to local utility companies is planned, with an improvement

[9] Fiscal Council's estimate.

of cost efficiency and increase in prices of certain utility services, privatisation or public-private partnership in local utility companies that are not natural monopolies.

The structure of subsidies to agriculture is also planned to change towards encouraging investment in order to increase its productivity and competitiveness, as well as improve agricultural infrastructure.

Knowledge-based economic growth implies providing appropriate subsidies for research and development, as well as environmental protection.

Subsidies for investment and employment will also be restricted depending on the effects of this investment on production, exports, employment and public revenue. In parallel with this, general conditions for investment and doing business will be improved, which will be the main incentive for foreign direct investment inflow. Special attention will be paid to large investment with significant impacts on the growth of economic activity and employment. The orientation is to offset the high direct and indirect subsidies by improving the business environment through continuing with the “guillotine” of regulations, reducing the number of days and the number of procedures for obtaining building permits, transfer of land, greater labour market flexibility, better protection of competition, lower tax burden and quasi-fiscal burden.

A transparent system of planning, allocating and supervising the spending of all budget subsidies will be established. All subsidised programmes will be integral parts of the budget law for the following budget year. The competent ministry will submit to the Government twice a year the report on the manner of allocating subsidies and the effects of the subsidies allocated.

Reforms Improving the Pension System

The high share of net pension expenditure in GDP (14.5% of GDP in 2012) resulted from the conditions for acquiring the right to pension, low economic growth rate, employment decrease and deficiencies in the collection of pension and disability insurance contributions.

In order to reduce transfers from the central budget to the state-owned PDIF in the medium term, the plan is to improve the revenue of the state-owned pension fund through improved records of the contributors and more efficient collection of pension and disability insurance contributions. To this end, a reform of the pension administration and the creation of the Central Registry of Mandatory Social Insurance were undertaken. At the same time, conditions will be created for reducing the share of pension expenditure in GDP through developing the economy and increasing the employment, while reducing the grey economy (unofficial work), as well as through adjusting the pension system parameters to economic capacity.

In order to increase the fiscal sustainability of the pension fund and reduce the share of pension expenditure in GDP, the conditions for acquiring the pension insurance rights will be tightened. The high share of pension expenditure in GDP is a consequence not only of slower growth and employment reduction, but also of different mechanisms that encouraged early retirement in the past, as well as of the demographic ageing and weaker collection of contributions, which increases the number of pension beneficiaries relative to the number of the employees who pay the contributions. More recently, an increase was recorded in the average age of new pensioners and in the number of years of service reached.

The objective of the pension reform is to reduce transfers from the republic budget to the state-owned pension fund and to reduce the increase in the number of pensioners by introducing penalties for early retirement, tightening the conditions for pensions based on extra service credit and a covenant on the right to old age pension for the contributors who paid their contributions in full to the pension fund, in accordance with the best international practice. In addition to these structural measures, it is necessary to create conditions for promoting the system of voluntary pension insurance and other forms of citizens’ savings.

The establishment of a fiscally sustainable pension system against the backdrop of accelerated ageing of the population requires the provision of greater incentives in the labour market with the aim of ensuring an increase in the number of contributors relative to the number of pensioners (the support ratio) by new employment. The fiscal sustainability of the pension system will be contributed to by acceleration of economic growth, reduction of unemployment, better collection of pension insurance contributions as well as changes in the mandatory pension insurance parameters (retirement requirements, status of specific groups) in accordance with demographic trends and economic capacity.

By amendments to the Law on Pension and Disability Insurance in the first half of 2013, actuarial equity factors will ensure that the workers who retire before the prescribed age limit for retirement to receive a proportionally lower amount of pension and for the workers who retire after the prescribed age limit to have a proportionally higher amount of pension depending on the expected duration of receiving the pension. Amendments to this Law will determine the percentage of pension decrease or increase for each year of retirement before or after the prescribed age limit. By implementing these measures, savings of around 0.1% of GDP are expected in the first years of implementation and 0.4% of GDP when full long-term effects of introducing the actuarial equity factors are achieved.[10]

In the medium term, an adequate system of automatic stabilisers will be implemented, which will adjust the pension insurance system to the population ageing in order to maintain the stability and solvency of the pension system.

Reforms Improving the Health Care System

The improvement of the health care system will continue in order to increase the financial sustainability of the health care system, in accordance with the strategic documents and systemic laws adopted. The main objectives of the health care reform are to increase the efficiency of the health care system, improve the health of the population and increase the quality of health care. These objectives may be achieved by refocusing from curative to preventive medicine and improving the system of accreditation and certification of health care institutions, along with establishing the system of mandatory certification of minimum standards (e.g. safety of patients). To that end, the current cost-based method of funding will be replaced with performance-based funding (capitation) by implementing the system of diagnosis-related and similar groups (the so-called DRG – Diagnosis-Related Group system) and the system of payment for service. The health care system will also be streamlined, primarily by reducing the number of non-medical staff, rationalising the number of hospital beds and ensuring better supervision of expenditure for medical services. This will increase the efficiency of health care institutions, provide the evaluation of their actual performance and increase the quality of health care. Significant savings and reduction of corruption in the health care are expected on this basis, as well as the provision of more funds for the health care system modernisation (top quality medical equipment).

In terms of funding health care in accordance with the new method of payment for health care services in public health care institutions with which the Republic Health Insurance Fund concluded the agreements on health care provision, transition will be provided to payment for services provided at the primary health care level by the selected physician according to the per capita model and at the secondary and tertiary health care levels according to diagnosis-related groups.

The ineffective structure of staff employed in health care institutions funded by mandatory health insurance will be adapted to the real needs of the health care system, within the limits of available funds. At the same time, the number of unsuitable non-medical staff will be decreased,

[10] Estimate of the Fiscal Council and the Ministry of Finance and Economy

while the number of medical staff needed for patient treatment and care and for introduction of new health care technologies will be increased.

Amendments to the Law on Health Care will reform the method of funding the procurement of medicines and medical supplies by introducing centralised public procurement of medicines, medical equipment and medical supplies and, if necessary, by adopting other measures as well, with the aim of preventing the generation of new debts and securing savings of minimum 20% in the RHIF, with greater liquidity in the operation of the pharmaceutical industry and stable functioning of the health care sector. An administration for centralised public procurement will be set up for the needs of health care institutions, which will start its operation by 31 March 2013. The establishment of the system of centralised public procurement for the needs of health care institutions that conclude agreements with the Republic Health Insurance Fund will contribute to the rationalisation of spending in the mandatory health insurance system and to the introduction of modern health care technologies.

Health insurance rights will be harmonised with the financial capacity of the Republic Health Insurance Fund, primarily at the primary health care level, by means of the "package of mandatory health insurance services".

Higher collection of health insurance contributions, as well as an improvement of the system and better organisation of operation of the RHIF will enable an elimination of arrears to pharmaceutical industry and regular supply of the market with medicines. The Law on Time Limits for Settlement of Financial Liabilities in Commercial Transactions provides for shortening the time limit for settlement of financial liabilities to the RHIF (150 days in 2013, 120 days in 2014 and 90 days in 2015). The savings in the health care sector will also be significantly increased by the creation of electronic files during 2013 as a centralised software system which will link in its network all health care institutions with the medical files of all patients in the country.

Priority areas in the development of health care in the following three-year period include preventive health care, improvement of the conditions for treatment and provision of mandatory health insurance for persons with no personal income. Continuous and high-quality training of medical staff and increasing the quality of medical services will also have priority, with further decentralisation of the health care system and enhancement of the role of local self-government units in the health care system.

Reforms Improving the Education System

The improvement of the education system will continue with the aim of increasing the quality, coverage, relevance and efficiency of education at all education levels, in accordance with the Strategy for Education Development in Serbia until 2020.

The improvement of pre-university education will ensure a more complete coverage of students by elementary and secondary education and an increase in the quality of elementary and secondary education through better conditions for teaching and learning, a higher quality of curricula and syllabi, teaching and learning, teachers and the quality of knowledge.

The improvement of university education will ensure the creation of scientific and professional knowledge that enables overall progress of the society and an increase in the share of population with university degree in total population, as well as a more complete presence of Serbia in the European Higher Education Area and the European Research Area.

The key mechanism for meeting the objectives of education is the introduction of the system of funding the pre-university education according to the number of students, depending on the educational needs and social and economic characteristics of local communities. The funding of higher education will also be improved with the aim of primarily ensuring an increase in the quality of university education and then an increase in the number of students and an increase in the efficiency of studying.

The adjustment of curricula and study programmes to the requirements of the modern labour market and more efficient funding aimed at planning the development of education and increasing the quality and efficiency of education are of special importance. The improvement of the quality of secondary education and the quality of public and private university education, as well as the matching of the demand for and supply of skilled workforce, in the conditions where the supply is excessive in some professions and insufficient in others, are of special importance for active inclusion in the labour market. The role of the government is to improve systematically the quality of the curricula and teachers in the public education system and to perform a preventive regulatory function in private education.

The implementation of fiscal consolidation implies the achievement of savings also in the field of education, through streamlining the school network, particularly at the elementary education level, without affecting the quality of elementary, secondary and university education. The number of classes and the number of teaching staff will be adjusted to the rate of student enrolment in elementary and secondary schools and, if needed, the classes in the schools that do not have a sufficient number of students will be merged.

Reforms Improving the Social Security System

The improvement of the social security system will continue in accordance with the Strategy for the Development of Social Security, the Law on Social Security and the Family Law. To this end, a better targeting of social security and more efficient funding of the programmes of cash welfare benefits and child allowances will be provided. Higher financial support will be provided to the poorest families and vulnerable groups and administrative barriers to getting welfare will be reduced.

The improvement of the financial sustainability of the social security system requires improving the availability and quality of social security, as well as reducing administrative barriers to getting means-tested welfare. The plan is to rationalise the number of social security beneficiaries based on means-testing the recipients of maternity, child and veterans' benefits as the most expensive social welfare programmes and a significant reduction of costs is expected on this basis.

The social policy will be aimed at the programmes for protecting the poorest strata of the population, for the purpose of ensuring the sustainability of allocations for social welfare. To this end, social maps will be made during 2013 in order for the social welfare to be received by the beneficiaries who need it. Local self-governments will play an active role in providing social care to poor citizens, providing funds for social security programmes, primarily for poor families not receiving any support from the budget of the Republic. Selectivity and targeting of social policy will be ensured at the republic and local level in order for the limited funds of the budget to be used by the families and persons who need the support most.

Reforms Improving Local Public Finance Management

Improved management of local public finance will be ensured through:

1) limiting the increase in employment, wages and subsidies in local self-governments, as well as transferring certain competences from the level of the Republic to local self-governments in the fields of transport infrastructure, education, health care and social security;
2) increasing the efficiency of services provided by local self-governments by means of greater investment in local development projects and increase in the cost efficiency of investment;
3) accelerating the process of property restitution to local self-government units;
4) improving the business environment at the local level through removing administrative barriers, abolishing unnecessary red tape, introducing e-government and reducing corruption.

In order to strengthen the fiscal responsibility of local self-governments, the Law on Local Self-Government Financing will be amended, establishing connection between the amount of funds transferred to a local self-government unit and the amount of own revenue collected in the territory of that local self-government unit. The changes in the system of local self-government financing also imply that the law determines the criteria for establishing the level of development, which are the elements of calculating the amount of transfers to individual local self-government units. The objective of the changes is to provide more efficient local public finance capacity utilisation, with the effects of the proposed measures being estimated at around 1% of GDP in the medium term.[11]

[11] Estimate of the Fiscal Council

V. Matrix of Economic Policies and Structural Reforms in The Period 2013-2015

No.	KEY AREAS	MAIN OBJECTIVES	KEY MEASURES AND ACTIVITIES	EXPECTED EFFECTS	ASSESSMENT OF FISCAL IMPLICATIONS	COMPETENT INSTITUTIONS	PREPARATION PERIOD	IMPLEMENTATION PERIOD
			ECONOMIC POLICIES IN THE PERIOD 2013-2015					
			1. Macroeconomic policy					
1.1.	**Economic policy**	Acceleration of EU integration	Implementation of systemic reforms by passing new systemic laws and implementing adopted laws Fulfilment of the SAA obligations Meeting the Copenhagen criteria for EU membership	Getting the date for the start of the EU accession negotiations in 2013 Acceleration of negotiations by SAA chapters		Government and ministries within their respective competences	Q4 2012	2013-2015
		Macroeconomic stability	Coordination of fiscal and monetary policy Reduction of macroeconomic imbalances – inflation, fiscal deficit, current account deficit	Reduction of inflation to 5.5% in 2013, 5% in 2014 and 4.5% in 2015 Reduction of the fiscal deficit to 3.6% of GDP in 2013 and 1% of GDP in 2015 Reduction of the current account deficit to 9% of GDP in 2013 and 7% of GDP in 2015		Government and ministries within their respective competences		
		Economic recovery and growth acceleration	Promoting the recovery and strengthening of the economy Attracting domestic and foreign investors Credit support of banks to the real sector Improving the infrastructure Improving the business environment Reducing the public spending Increasing the capital spending	Moderate economic recovery of 2% in 2013 and acceleration of economic growth to 3.5% in 2014 and 4% in 2015 Increase in the growth rate of exports of goods and services from 1.8% in 2012 to 11.1% in 2015 Increase in national savings from 3.8% of GDP in 2012 to 8.5% of GDP in 2015 Increase in investment from 14.6% of GDP in 2012 to 16.8% of GDP in 2015 Increase in the productivity growth rate from -0.8% in 2012 to 1.7% in 2015 Increase in competitiveness		Government and ministries within their respective competences		
		Increase in employment and the standard of living	Removing institutional and structural restrictions to economic growth Increasing investment in new jobs Active employment measures Wage increase according to the increase in productivity	Deceleration of decrease in employment in 2013 (-0.2%) Increase in employment by 1.2% in 2014 and 2.3% in 2015 Increase in net wages and personal spending of households		Government and ministries within their respective competences		

No.	KEY AREAS	MAIN OBJECTIVES	KEY MEASURES AND ACTIVITIES	EXPECTED EFFECTS	ASSESSMENT OF FISCAL IMPLICATIONS	COMPETENT INSTITUTIONS	PREPARATION PERIOD	IMPLEMENTATION PERIOD
1.2.	**Fiscal policy**	Application of the determined fiscal rules relating to fiscal deficit and public debt Bringing public debt of general government back to sustainable level Better management of public expenditure and fiscal deficit Reduction of the share of public expenditure and fiscal deficit in GDP Maintenance of stable tax burden on the economy while strengthening tax compliance Strengthening financial discipline in public enterprises at the republic level and local levels	***Key structural measures on the revenue side***: Competitive and efficient tax system Predictable tax policy Bringing indirect tax policy into compliance with the EU rules Simplifying the tax process and procedures Modernising and increasing the efficiency of tax administration Full tax compliance ***Key structural measures on the expenditure side:*** Matching the growth of wages in the public sector and pensions with the real capacity of the budget Standardising the rules for determining wages across the public sector Completing the restructuring of state enterprises by 30 June 2014 Improving the rules of corporate governance of public enterprises Reducing direct and indirect subsidies to state enterprises Tightening the conditions for acquiring pension insurance rights Streamlining the network of public educational and health care institutions Reorganising and increasing the efficiency of operation of mandatory social insurance funds Improving the social security system	Reduction of fiscal deficit from 6.1% of GDP in 2012 to 1% of GDP in 2015 Reduction of the general government debt from 65.1% of GDP in 2012 to 58.4% of GDP in 2015 Determination of sustainable path of public debt reduction to 45% of GDP		Ministry of Finance and Economy	Q4 2012	2013-2015

No.	KEY AREAS	MAIN OBJECTIVES	KEY MEASURES AND ACTIVITIES	EXPECTED EFFECTS	ASSESSMENT OF FISCAL IMPLICATIONS	COMPETENT INSTITUTIONS	PREPARATION PERIOD	IMPLEMENTATION PERIOD
1.2.1.	**Public revenue**	Fiscal consolidation on the revenue side	Increasing tax rates, mostly of indirect taxes Expanding the tax base for all tax types Strengthening the capacity of tax administration Increasing the tax collection efficiency	Effects of tax measures in 2013 reduce the deficit by around 2% of GDP, and savings on the expenditure side reduce the deficit by 1.3% of GDP	The effect of the tax measures taken in 2013 on deficit reduction is, according to the estimates, RSD 135.4 billion	Ministry of Finance and Economy	Q4 2012	2013-2015
			Personal income tax	Increase in the share in GDP from 5.1% in 2012 to 5.4% in 2015				
			Contributions for mandatory social insurance organisations	Increase in the share in GDP from 11.3% in 2013 to 11.5% in 2015				
			Corporate income tax: increasing the rate from 10% to 15%	Increase in the share in GDP from 1.7% in 2012 to 2.2% in 2015	The effect is around RSD 23 billion in 2013			
			Value added tax	Increase in the share in GDP from 11.5% in 2012 to 11.6% in 2015				
			Excise duties	Increase in the share in GDP from 5.9% in 2012 to 6.4% in 2015				
			Customs duties	Reduction of the share in GDP from 1.1% in 2012 to 0.8% in 2015				
			Other tax revenue	Reduction of the share in GDP from 1.3% in 2012 to 1.2% in 2015				
			Other non-tax revenue	Reduction of the share in GDP from 5.4% in 2012 to 4.5% in 2015				
			Implementation of the Law on the Conditional Write-off of Interest and Tax Debt Standstill		Minimal effect in 2013 is RSD 3.5 billion			
1.2.2.	**Public expenditure**	Fiscal adjustment in the current expenditure account Increase in capital expenditure	Limited growth of public sector wages and pensions Reduction of subsidies Savings in the budget at all government levels More efficient public procurement process Completion of the restructuring process Redefining the measures of support to the economy	Fiscal adjustment in the expenditure account is 5.1 pps in 2012-2015		Ministry of Finance and Economy	Q4 2012	2013-2015
			Employee expenditure	Reduction of the share in GDP from 11.5% in 2012 to 10.8% in 2015				
			Purchase of goods and services	Reduction of the share in GDP from 7.6% in 2012 to 6.7% in 2015				
			Interest repayment	Reduction of the share in GDP from 2.6% in 2013 to 2.3% in 2015				
			Social welfare and transfers	Reduction of the share in GDP from 20% in 2012 to 17.6% in 2015				
			Subsidies	Reduction of the share in GDP from 3.4% in 2012 to 2.6% in 2015				

			Capital expenditure	Increase in the share in GDP from 3.5% in 2012 to 3.7% in 2015				
1.3.	**Monetary policy**	Price stability Stability of the financial system Support to economic growth and employment	Monetary policy aimed at achieving low and stable inflation in the medium term The main monetary policy instrument is the key policy rate applied in major open market operations Strengthening the market instruments of monetary regulation Measures for maintaining the financial system stability Implementing the managed floating exchange rate regime Measures for increasing the degree of dinarisation that will contribute to reducing the sensitivity to the dinar exchange rate fluctuations Tight coordination of monetary policy and fiscal policy	Target inflation for 2013 is 4.0% ±1.5 pps Target inflation for 2014 is 4.0% ±1.5 pps		National Bank of Serbia	December 2012-January 2013	2013-2015
2. Special economic policies								
2.1.	**Competition protection policy**	Protection of competition in the regulated market	Sanctioning all forms of abuse of monopoly and dominant position and all other forms of competition violation			Commission for Protection of Competition	November 2012-June 2013	July 2013-2015
2.2	**Population policy**	Interrupting the decline of population numbers Increase in the birth rate	Incentives for having more children Support to married couples who need in vitro fertilisation Support to pregnant women and new mothers Greater social care of children Introducing the VAT refund for purchase of baby supplies for poorer population categories	Population increase Interruption of the population drain		Ministry of Labour, Employment and Social Policy Ministry of Finance and Economy	November 2012-June 2013	July 2013-2015
2.3.	**Employment policy**	Increase in the number of the employed	Promotion of employment Social inclusion of hard-to-employ persons, especially the vulnerable categories of the unemployed Creating new jobs through improving the investment and business environment Support to the development of social entrepreneurship	Deceleration of decrease in employment in 2013 Acceleration of increase in employment of the working-age population in 2014 and 2015		Ministry of Labour, Employment and Social Policy Ministry of Finance and Economy	November 2012-June 2013	July 2013-2015
2.4.	**Policy of balanced regional development**	Sustainable development of all regions of the Republic Increase in regional competitiveness Reduction of regional imbalances and differences in the development level Interruption of unfavourable demographic trends Strengthening	Promoting balanced development of all regions of the Republic, including development of underdeveloped regions Investments by the Development Fund in underdeveloped regions under more favourable conditions than market conditions	Reduction of differences in the development level of some regions of the Republic of Serbia		Ministry of Regional Development and Local Self-Government	November 2012-June 2013	July 2013-2015

		decentralisation						
2.5.	**Social policy**	Ensuring social security of population	Increasing the efficiency of provision of social services Protection of family, children and youth and persons with disability and their social integration, protection of low-income pensioners and elderly persons Support to the poorest citizens and employment of marginalised social groups that are uncompetitive in the labour market Social care of children and support to mothers, especially in rural areas Sanctioning all forms of violence against women and children and peer violence	Reduction of poverty of the population and an increase in the birth rate Reduction of the share of allocations for social welfare and transfers in GDP from 20% in 2012 to 17.6% in 2015		Ministry of Labour, Employment and Social Policy Ministry of Finance and Economy	November 2012-June 2013	July 2013-2015
3. Sectoral economic policies								
3.1.	**Agriculture**	Food security Organic agriculture Better conditions in rural areas	Increasing allocations for promotion of agricultural production Attracting foreign direct investment Fairer distribution of subsidies Guaranteed system of incentives for minimum five years Provision of incentives for investment in agriculture, especially in irrigation systems	Increase in agricultural production and yield per hectare Higher stage of product processing		Ministry of Agriculture, Forestry and Water Management Ministry of Finance and Economy	November 2012-June 2013	July 2013-2015
3.2.	**Industry**	Increase in the competitiveness of industry Increase in industrial exports Increase in the exports growth rate and the share of exports in GDP	Attracting foreign investment in export-oriented industries Supporting the exports of metal, automobile, electronic, food, pharmaceutical and military industries Completion of the restructuring of large industrial systems More efficient bankruptcy procedure for industrial enterprises without business prospects Connecting small and medium-sized enterprises with large industrial systems	Strengthening the exports supply Increase in exports volume Increase in the number of employees Higher stage of product processing Breaking into new export markets		Ministry of Finance and Economy Ministry of Foreign and Domestic Trade and Telecommunications	November 2012-June 2013	July 2013-2015
3.3.	**Mining and energy**	Sustainable use of natural resources Competitive energy sector	Increasing investment in opening new mining fields, construction of hydroelectric and thermoelectric power plants and renewable energy sources Defining pricing policies and price parities Increasing the production of heat and electricity in thermoelectric power plants and gradually replacing fuel oil and coal with gas and renewable sources, primarily biomass Promoting Serbia as a transit route and a storage place for energy and energy raw materials Constructing a second gas storage facility and electric power connection with neighbouring countries	Increase in energy efficiency Achievement of energy security of the country		Ministry of Natural Resources, Mining and Spatial Planning Ministry of Finance and Economy	November 2012-June 2013	July 2013-2015

			Establishing a market for energy and energy raw materials according to the EU standards (electricity, gas, oil products and liquefied petroleum gas)				
3.4.	**Transport**	Improved transport as a pillar of development	Completing the motorway through Serbia (Corridor 10) Constructing a motorway from Belgrade toward West Serbia (Corridor 11) and a motorway from Pojate to Preljina Connecting Kragujevac with Corridor 10, Zaječar and Bor and Corridor 10 Connecting Loznica and Šabac with Corridor 10 and with Novi Sad via Ruma by a tunnel through Fruška Gora Other infrastructural projects of importance for regional development	Acceleration of development of underdeveloped regions	Ministry of Transport	November 2012-June 2013	July 2013-2015
3.5.	**Telecommunications**	Faster and cheaper communications	Construction of modern optical infrastructure Modern electronic communications and broadband Internet access	Increase in the number of users of telecommunication services	Ministry of Foreign and Domestic Trade and Telecommunications	November 2012-June 2013	July 2013-2015
3.6.	**Tourism**	Well-developed tourist offer	Improving the services infrastructure	Increase in foreign currency inflow	Ministry of Foreign and Domestic Trade and Telecommunications	November 2012-June 2013	July 2013-2015
3.7.	**Health care**	Improvement of public health and increase in the efficiency of the health care system	Optimising the network of health care institutions	Rationalisation of expenses in health care and efficiency increase	Ministry of Health	November 2012-June 2013	July 2013-2015
3.8.	**Education**	Improvement of public and private education and full availability of education Increase in the quality and efficiency of the education system	Improving the elementary and secondary education Promoting education at higher education levels Increasing investment in the development of education infrastructure in line with the country's capacity Implementing a new system of education funding per student	Increase in the quality of education, more efficient studying, creation of a quality teaching staff	Ministry of Education, Science and Technological Development Ministry of Finance and Economy	November 2012-June 2013	July 2013-2015
3.9.	**Science**	Economic and social development based on knowledge and new technologies	Establishing public-private partnership for a faster development and implementation of innovations	Increase in productivity and competitiveness, and thus in the productive connection between science, education and economy	Ministry of Education, Science and Technological Development	November 2012-June 2013	July 2013-2015

No.	KEY AREAS	MAIN OBJECTIVES	KEY MEASURES AND ACTIVITIES	EXPECTED EFFECTS	ASSESSMENT OF FISCAL IMPLICATIONS	COMPETENT INSTITUTIONS	PREPARATION PERIOD	IMPLEMENTATION PERIOD
			STRUCTURAL REFORMS IN THE PERIOD 2013-2015					
			1. Real sector reforms					
1.1.	**Business environment**	Creation of a stimulating business environment for businesspeople and investors and conditions for doing business more easily Increase in the legal security of doing business and investing in Serbia	Reducing administrative barriers and reducing and simplifying red tape at the national level and local levels Simplifying tax payment Faster and cheaper issuance of building permits Faster registration of property Improving the infrastructure in the fields of energy, transport and communications Improving the competition policy and strict implementation of the legal framework Establishing financial discipline by passing the law on timely payment and the law on the deadlines for settlement of financial liabilities in commercial transactions and by efficient implementation of bankruptcy legislation Regulating property rights that ensure efficient functioning of market economy Reform and modernisation of inspectorates according to the EU standards Completing the harmonisation of standards Improving the national quality assurance infrastructure Passing a law on fees for the use of public assets	Reduction of costs for businesses Investment increase Growth of economic activity Reduction of unemployment Better conditions and greater ease of doing business Improvement of transparency of the public revenue system and ensuring the predictability of operating costs for businesses Improvement of business environment and prevention of failures to settle financial liabilities on time between the public sector and businesses	Annual net foreign direct investment and portfolio investment will be around EUR 2.3 billion on average in 2013-2015	All ministries within their respective competences	November 2012-June 2013	July 2013-2015
1.2.	**Land policy**	Improvement of the building permit issuance procedure Promotion and growth of investment	Increasing the security of property rights Simplifying and shortening the procedure for permit issuance and legalisation of buildings and settlements Consolidating agricultural land Training land administration staff at the central level and local levels Accelerating the procedure of land expropriation for implementation of infrastructural projects More efficient implementation of the single cadastre system of land registration Adopting a national land management programme Law on Planning and Construction Improving the mortgage over land by passing a new mortgage law Amendments to the Law on Contracts and Torts and the regulations regulating the construction process Simplifying and accelerating the land expropriation procedure	Easier, faster and cheaper process of obtaining building permits Promotion and growth of investment More efficient real property market Consolidation of agricultural land Faster registration of title over land Reduction of the number of institutions to which applications are to be submitted and introduction of a one-stop shop system for investors Improvement of land valuation Improvement of investor-contractor relations Reduction of construction land development fee Faster collection of data on land and introduction of the One-Stop-Shop Information System		Ministry of Construction and Urban Planning Ministry of Agriculture, Forestry and Water Management	November 2012-June 2013	July 2013-2015
1.3.	**Labour market**	Improvement of the labour market and increase in the quality of workforce Greater flexibility and mobility of the labour market Better match between supply and demand in the labour market	Implementing the National Employment Strategy Until 2020 Implementing the programmes and active employment policy measures Adopting annual employment action plans Promoting professional development of employees through developing a career guidance and counselling system Occupational rehabilitation measures Preparing a National Qualifications Framework Preparing a National Job Classification system Increasing the funds for active job seeking, programmes	Reduction of unemployment Increase in the employment rate Increase in the labour market flexibility and mobility Reduction of labour costs Reduction of unofficial labour Promoting the creation of new jobs Match between job supply and demand Simplification of the procedure of obtaining business visas and residence permits	According to the estimate of the Ministry of Labour, Employment and Social Policy, it is necessary to allocate 0.1% of GDP in 2013 and 0.2% of GDP in 2014 for active employment	Ministry of Labour, Employment and Social Policy	November 2012-June 2013	July 2013-2015

			of additional education and training, subsidies for employment and public works Programmes of additional education and training for unemployed persons Improving the labour and employment regulations towards: - eliminating the barriers in hiring and firing (duration of fixed-term contracts, secondment, rescheduling of working hours), - changing the structure and calculation of wages and severance pays, - reforming collective bargaining (extended effect of collective bargaining agreements, representativeness of participants in the social-economic dialogue), - simplifying the rules that hinder employment and doing business Improving the legal framework for the self-employed		measures and the budget fund for occupational rehabilitation and promotion of employment of persons with disability			
1.4.	**Exports promotion**	Acceleration of the growth of exports as the main driver of economic growth Increase in the share of exports in GDP Reduction of the current account deficit Support to the exports of competitive industries and products Increase in the productivity, competitiveness and exports of agricultural products	Promoting economic growth that relies on exports and increasing the competitiveness of export-oriented sectors Eliminating administrative barriers to domestic and foreign investors Supporting the exports of products of automobile, metal, electronic, food and military industries as sectors with competitive advantages Supporting the exports of services, especially in the field of information technology and exports of telecommunication services Promoting the sales and service provision over the Internet Supporting the growth of production, productivity, competitiveness and exports of agricultural products through increasing the agrarian budget and promoting investment in agriculture Accelerated restructuring of the agricultural sector according to the EU standards and increasing investment in the development of agricultural infrastructure Building an effective advisory service and changing the behaviour of farmers Improving the supply chain Continuing the trade liberalisation while reducing customs protection, with the possibility of abolishing export subsidies	Growth of exports of goods and services by 12.1% in 2013-2015 Reduction of deficit of goods and services from 18.9% of GDP in 2012 to 12.8% in 2015 Lower level of current account deficit (including subsidies) with a 7% share in GDP at the end of 2015 Reduction of external imbalance and the risk of sustainability of external debt and external liquidity Increase in the competitiveness of agriculture in the global market Increase in the GVA of agriculture by 3.3% in 2014 and 3.8% in 2015		Ministry of Foreign and Domestic Trade and Telecommunicatio ns Ministry of Agriculture, Forestry and Water Management Ministry of Finance and Economy	November 2012-June 2013	July 2013-2015
			2. Public sector reforms					
2.1.	**Public finance reforms**	Improvement of public finance management Introduction of budget programming	*On the revenue side*: Competitive, efficient and fair tax system Predictable tax policy Gradual bringing of the indirect tax policy into compliance with the EU rules Increasing indirect taxes Reducing the tax burden on labour Simplifying the tax process and procedures Modernising and increasing the efficiency of tax administration, especially in combating grey economy The tax base will be expanded by passing a new law on	Reduction of the general government's role in the economy and an increase in its efficiency in realising the general interests of the society Increase in horizontal and vertical fairness of taxation Reduction of the share of public revenue	Savings of around 0.4% of GDP at the annual level would be generated based on the rationalisation of the system of wages and the	Ministry of Finance and Economy Ministry of Justice and Public Administration Ministry of Labour, Employment and Social Policy	November 2012-June 2013	July 2013-2015

		Reduction of public spending Reduction of tax burden Sustainable fiscal deficit Sustainable public debt of the Republic	personal income tax Amendments to the Law on Property Tax towards changing the method of tax base evaluation for entities that keep books Modernising the tax administration *On the expenditure side:* Determining the medium-term expenditure framework Measures for reducing fiscal deficit and balancing the budget Matching the growth of wages in the public sector and pensions with the real capacity of the budget Reforming the system of wages and hiring in the public sector Introducing uniform pay grades in government and public services Programme of staffing rationalisation in the general government Introducing the single registry of employees in the general government Reforming the pension, health and social insurance funds Reforming the state and public enterprises Reforming the system of subsidies Reforming the systems of education, health care and social security Improving fiscal decentralisation	(excluding indirect beneficiaries) to 43.7% of GDP in 2015 Reduction of the share of public expenditure (excluding indirect beneficiaries) to 44.7% of GDP at the end of 2015 Reduction of fiscal deficit to around 1% of GDP at the end of 2015 Interrupting the growth of public debt and reducing its share in GDP from 2014 Reduction of administration costs Increase in the efficiency of the public sector and assuring the matching of costs with the capacity and productivity of economy Reduction of the number of employees in government administration and public services by minimum 5%	number of employees in the government administration and public services at all government levels A significant additional increase in public revenue may be achieved in the medium term based on combating the grey economy and tax evasion, depending on the turnover in the grey economy			
2.2.	**Reform of state-owned and public enterprises**	Increase in the operating efficiency and professionalisation of the public sector Reduction of budget subsidies	Completing the process of restructuring state enterprises until 30/06/2014 at the latest Accelerating the restructuring of public enterprises and increasing the efficiency in their operation Changing the privatisation concept towards introducing new privatisation models and methods Corporatisation of public enterprises Professionalising the management of public enterprises Reducing direct and indirect subsidies to state enterprises Liberalising the infrastructural activities performed by public enterprises, except natural monopolies Increasing the cost efficiency of public enterprises and bringing the prices of their products and services to the economic level (costs+)	Increase in the efficiency of the overall economy and reduction of losses of the public sector Improvement of the quality of services of public enterprises Growth of economic activity and employment in the private sector Establishment of financial discipline and level playing field for all Decrease in corruption and crime	Budget savings in subsidies of around 0.6% of GDP in 2013-2015	Ministry of Finance and Economy	November 2012-June 2013	July 2013-2015
2.3.	**Reform of the system of subsidies**	Reduction of total expenditure for subsidies Increase in the efficiency of the programmes of subsidies	Full abolishment of direct and indirect subsidies to state enterprises as of 2015 More efficient operation of the railway company and limiting its annual subsidies to maximum 0.5% of GDP Reducing subsidies to local utility companies, while improving their cost efficiency and increasing the prices of particular utility services Privatisation or public-private partnership in local utility companies which are not natural monopolies Changing the structure of subsidies in agriculture in favour of grants for promoting investment in order to increase the productivity and competitiveness and improve the agricultural infrastructure Adequate subsidies for research and development and for environmental protection	Budget balancing and sustained public finance consolidation		Ministry of Finance and Economy	November 2012-June 2013	July 2013-2015

			Subsidies for investment and employment will be restricted depending on the effects of this investment on production, exports, employment and public revenue A transparent system of planning, awarding and supervising the spending of all budget subsidies will be established					
2.4.	**Pension system reform**	Increase in the fiscal sustainability of the pension system Reduction of the share of pension expenditure in GDP Adjusting the pension system to demographic changes	Amendments to the Law on Pension and Disability Insurance Introducing penalties for early retirement Tightening the conditions for pensions based on extra service credit Protecting the right to old-age pension to the contributors who paid their contributions in full to the state-owned pension fund Promoting employment in order to increase the number of the contributors relative to the number of pensioners (support ratio) Promoting the system of voluntary pension insurance Increasing the revenue of the state-owned pension fund through improving the records of the contributors and a more efficient collection of pension and disability insurance contributions Reforming the pension administration and creating a central registry of mandatory social insurance Developing the economy and increasing employment, while reducing the grey economy as the basis for long-term fiscal sustainability of the pension system Adjusting the parameters of the pension system (conditions for retirement) to the demographic trends and economic capacity	Reduction of budget transfers to the state-owned pension fund Reduction of the increase in the number of pensioners		Ministry of Labour, Employment and Social Policy Ministry of Finance and Economy	November 2012-June 2013	July 2013-2015
2.5.	**Health care system reform**	Improving the health of the population Increasing the financial sustainability of the health care system Increase in the efficiency of the health care system Increase in the quality of health care	Introducing a more efficient system of public health funding – payment for services provided at the primary health care level by the selected physician according to the per capita model and at the secondary and tertiary health care levels according to diagnosis- related groups Rationalising the health care system through reducing the number of non-medical staff, rationalising the number of hospital beds and better supervision of expenditure for medical services Increasing the number of medical staff needed for treatment and care of patients and for introduction of new health care technologies Better supervision of expenditure for medical services Matching the health insurance rights with the financial capacity of the Republic Health Insurance Fund, primarily at the primary health care level, by means of a “package of mandatory health insurance services” Improvement of the system and a better organisation of operation of the Republic Health Insurance Fund for the purpose of eliminating arrears to pharmaceutical industry and regular supply of the market with medicines Centralised public procurement of medicines, medical equipment and medical supplies Setting up the Administration for Centralised Public Procurement	Satisfaction of health care users by the health services provided Higher efficiency of preventive and curative medicine Reduction of corruption in the health care	Savings based on the introduction of the system of centralised public procurement of minimum 20% in the RHIF	Ministry of Health Ministry of Finance and Economy	November 2012-June 2013	July 2013-2015

			Increasing investment in the modernisation of the health care system (top quality medical equipment) Improving the collection of health insurance contributions Faster integration of private health care into the health care system Continuous and high-quality training of medical staff and increasing the quality of medical services Improving the system of accreditation and certification of health care institutions Further decentralisation of the health care system and increasing the role of local communities in the field of health care Bringing the legal regulations into compliance with the EU legislation and passing the law on funding mechanisms, private service providers and reporting					
2.6.	**Education system reform**	Increase in the quality, coverage and efficiency of education Increase in the financial sustainability of public education Match between education and the labour market needs	Rationalising the national network of elementary and secondary schools Introducing the performance-based funding into the system of public education at all education levels Improving the quality of curricula and the quality of teachers and matching them with the real needs of the society	Improvement of the education system Increase in the quality of knowledge and skills of workforce Increase in the share of the population with university degrees in the total population		Ministry of Education, Science and Technological Development Ministry of Finance and Economy	November 2012-June 2013	July 2013-2015
2.7.	**Social security system reform**	Improvement of the availability and quality of social security Improvement of the financial sustainability of the social security system	Matching supply and demand in the labour market Better targeting of social policy and greater selectivity of social security based on social maps More efficient funding of the programmes of cash welfare benefits and child allowances Providing greater financial support to the poorest families and vulnerable groups Reducing administrative barriers to getting means-tested social welfare Rationalising the number of social security beneficiaries based on means-testing the recipients of maternity, child and veteran benefits Local self-government units will provide funds for social security programmes, primarily for poor families not receiving any support from the budget of the Republic	Increase in the level of expenditure for social welfare programmes		Ministry of Labour, Employment and Social Policy Ministry of Finance and Economy	November 2012-June 2013	July 2013-2015
2.8.	**Improvement of local public finance management**	Responsible local public finance	Limiting the increase in employment, wages and subsidies in local self-governments Greater investment in local development projects and increase in the cost efficiency of investment in order to increase the efficiency of services provided by local self-governments Devolution of certain competences from the central level to local levels in the fields of transport infrastructure, education, health care and social security with the aim of increasing their efficiency Accelerating the process of property restitution to local communities Improving the business environment at the local level by removing administrative barriers, abolishing unnecessary red tape, introducing e-government and reducing corruption Amendments to the Law on Local Self-Government Financing that establish connection between the amount of funds transferred to a local self-government unit and the amount of import revenue collected in its territory	Reduction of arrears of local communities to the private sector and republic public enterprises Increase in investment in local development projects Improvement of the state of local public finance	Budget savings based on more efficient local finance capacity utilisation are estimated at around 1% of GDP			July 2013-2015