Government of the
Republic of Serbia

Pre-accession Economic Programme for 2014

December 2013

Contents:

I. Overall Economic Policy Framework and Main Objectives

The Republic of Serbia, as a candidate country for membership in the European Union ("EU") has made its second Pre-accession Economic Programme ("PEP") for 2014. In the context of national procedures, PEP has been drawn up in cooperation with the National Bank of Serbia ("NBS") and the competent national ministries. The NBS has prepared the texts in Chapter II, item 3: Monetary Policy and Exchange Rate, External Sector and its Mid-term Sustainability and Financial Sector. The Government of the Republic of Serbia adopted the PEP on 30 December 2013 for the purpose of presenting it to the European Commission ("EC").

The overall economic policy framework for the period 2014-2016 consists of strategic development documents of the Serbian Government, including: the Stabilisation and Association Agreement between the European Communities and their Member States on the one side and the Republic of Serbia on the other side ("SAA"), the National Programme for the Adoption of the Acquis communautaire (2013 – 2016), overall and sector-specific national development strategies and the Fiscal Strategy for the Period 2014-2016. The economic policy for the coming mid-term period reflects the strategic development framework.

Upon obtaining the status of an EU candidate country on 1 March 2012 and after the SAA came into force on 1 September 2013, Serbia entered a new stage in the EU integration process, one in which the country's development processes will be shaped and guided on the basis of European standards. In this context, a strategic economic policy objective of the Serbian Government for the coming years is to expedite the EU integration process through EU accession negotiations and through systemic reforms aimed at ensuring compliance with the criteria set by the European Council in Copenhagen and acquiring the status of a full member of the EU. To that end, efforts will be made to expedite the enactment of all necessary systemic laws and enforcement of existing laws and implementing regulations will be ensured, with the aim of establishing market economy, macroeconomic stability and rule of law and eradicating corruption and organised crime.

To ensure compliance with the economic and political criteria for EU membership, Serbia intends to build its administrative capacities and ensure the stability of those institutions that guarantee democracy, rule of law, respect for human rights and protection of minorities, development of a market economy and increased resilience to the pressures of competition and market forces in the EU and creation of a stable economic and monetary climate.

Faster EU integration and economic integration will provide a strong impetus for the Serbian economy. In addition, the economy will receive a significant boost from the improved business environment, as well as from public sector reforms. Of particular importance for expediting the development processes will be the new investment cycle, supported by measures introduced by the Serbian Government, and the completion of restructuring and privatisation, to allow the private sector to emerge as the main driver of economic growth and to give the Serbian capital market a new impetus for growth.

On the other hand, development processes will be hampered by the vulnerability of the economy after the economic and financial crisis, illiquidity of the real sector, insufficient loan support to the real sector from banks, rising costs of structural reforms, insufficient investment capital to develop the tradable goods sector, unstable international environment and debt crisis in certain Eurozone countries.

In the coming years, economic policy will continue facing instabilities and risks in international relations, as well as inherited problems, primarily the macroeconomic imbalances that remain relatively high measured by international standards, uncertain outlook for real sector recovery, high unemployment and lower salaries, slow public sector reforms and high fiscal deficit and public debt. All of these are potential threats and risks for macroeconomic stability and economic growth in 2014 and the years to come.

Public debt stabilisation and recovery of the economy emerge as the main objectives of economic and fiscal policy. In the next three years the economy is expected to grow at an average of 1.6% per annum, as a result of fiscal consolidation and structural reforms, slow recovery of the global economy, in particular the European economies, lower aggregate demand and slow labour market adjustment. After that, economic growth is expected to gather momentum due to fiscal adjustment on the expenditure side and continued structural reforms, as well as due to more favourable influences from the European economic environment.

Economic growth and increased competitiveness of the economy will provide solid foundations for employment growth and better standard of living. Employment and standard of living are expected to gather pace once transition has advanced and once the economy has been restructured to eliminate institutional and structural restrictions and ensure more efficient management of the economic policy. After a sharp decline in employment and standard of living experienced between 2009 and 2013, the coming period will see faster economic growth, higher employment and better standard of living.

The main objectives of economic and fiscal policies for the next three years include:

- Debt stabilisation and creating a downward trend;
- Promotion of economic growth based on investment and exports;
- Growth of employment and standard of living once economic activity gathers momentum;
- Price stability and financial stability.

The primary goal of fiscal policy, as a key component of macroeconomic policy, is to curb debt growth and reduce debt as a share of gross domestic product (“GDP”).

To reduce fiscal deficit and public debt, the Serbian Government intends to implement a boldly ambitious fiscal consolidation and structural reform plan which will ensure stability of public finance and promote economic growth and competitiveness. It is necessary to close fiscal imbalances in order to improve sustainability of public finance and create conditions for economic recovery and development sustainable in the long term. This will be supported further by improvements in the business environment and a boost to development through efficient use of EU funds.

Fiscal consolidation measures and reforms focused on eliminating the economy's structural weaknesses, with a more favourable economic environment and expedited compliance with EU accession requirements, will put Serbian economy on a path of recovery and strengthening. This, in turn, will result in a gradual reduction of general government deficit and public debt.

Macroeconomic projections for the next three fiscal years anticipate modest economic growth, with a reduction of macroeconomic imbalances. To achieve economic growth, with lower inflation and lower current account deficit, Serbia will need to undergo a strict fiscal adjustment to cut public spending and implement structural reforms conductive to growth, competitiveness, exports and inflow of foreign direct investment in the industry and agriculture. Furthermore, the expected improved performance of the Eurozone economy will have positive spill-over effects on economic activity and employment in Serbia. In this context, growth of economic activity will reduce the need for financing the current balance of payments deficit and the public sector.

Crucial for the achievement of economic and fiscal policy objectives will be the implementation of the fiscal consolidation programme, the structural reform plan and the public debt reduction programme, which are the pillars of the Fiscal Strategy for the coming medium-term perspective. The establishment of macroeconomic stability through lower inflation, fiscal deficit and current account deficit will require close coordination between fiscal and monetary policies.

II. Economic Developments and Medium-term Prospects

1. Assessment of the International Economic Environment

Economic trends and prospects of Serbia in the medium term will be strongly influenced by the trends and prospects in the international economic environment, including in particular the eurozone member states as Serbia's main partners in commodity trade and investment.

According to the Eurostat figures, yearly GDP decline has slowed down in the eurozone countries from 1.2% in Q1 2013 to 0.6% in Q2 and 0.4% in Q3. In this period GDP decline in the EU-28 has also slowed down from 0.8% in Q1 to 0.2% in Q2 and than achieved growth rate of 0.1% in Q3. It is estimated that economic activity in the eurozone will embark on a path of recovery also in the Q4 of 2013, with the prospect of becoming viable in 2014, which will have a positive impact on economic trends and prospects for Serbia and other countries in the region.

According to the forecasts announced by the International Monetary Fund (IMF) in October, the slow pace of economic growth will continue through 2013 due to low demand, slowdown in several key emerging economies, prolonged recession in the eurozone and increasing volatility in the global financial market. In the first half of 2013, the global growth has remained at a relatively modest level of 2.5%. Global economic growth in real terms in 2013 has been downgraded to 2.9%, while in 2014 it is expected to reach 3.6%. The main impetus to global growth is expected to come from the developed countries. The projected growth in developing countries in 2014 is 5%. According to the IMF forecasts, unemployment will remain at the current level in most of the developed countries and in a number of developing countries. A key risk for this projection concerns primarily to the uncertainty surrounding continued expansive monetary policies in the USA, the limitations of fiscal policy measures and inflationary pressures in the developing countries, as well as the willingness of the EU to put in place specific reforms to promote growth.

In the October survey, the IMF states that the eurozone will experience a mild recession of -0.4% in 2013, while the EU-28 states are expected to face a stagnation of economic activity. The eurozone will face significant risks unless banking system restructuring and public debt stabilisation measures are put in place in its Member States, which will require fixes to the financial system and the establishment of a banking union in the eurozone. The IMF forecasts indicate that the eurozone - after the recession in 2013 – will speed up its economic growth by 1% in 2014, mainly due to the fiscal easing from 1% of GDP in 2013 to 0.5% of GDP in 2014. For 2015 and 2016 estimated GDP growth for Euro zone is 1.4% and 1.5%, respectively.

Table 1 International Environment - Macroeconomic Indicators

	2012	2013	2014	2015	2016
GDP growth in real terms[1], %					
World total	3.2	2.9	3.6	4.0	4.1
European Union	-0.3	0.0	1.3	1.6	1.8
United States	2.8	1.6	2.6	3.4	3.5
Developing countries	4.9	4.5	5.1	5.3	5.4
World trade growth, %	2.7	2.9	4.9	5.4	5.6
Unemployment rate, %					
Eurozone	11.4	12.3	12.2	11.9	11.5
United States	8.1	7.6	7.4	6.9	6.4
Consumer prices, annual change, %					
Developed economies	2.0	1.4	1.8	1.8	1.9
Developing countries	6.1	6.2	5.7	5.2	5.0
Oil price increase, in dollars, annual changes, %	1.0	-0.5	-3.0	-5.9	-4.3

[1] World GDP calculated by purchasing power parity.

Source: IMF, World Economic Outlook, October 2013

From 2014 until 2016, the IMF expects that the global economic growth will be accompanied by fiscal adjustment, improvement of conditions in the financial markets and more favourable labour market conditions. Significant improvements in the budget balance, a gradual increase of bank lending operations and growing private domestic demand are expected to be the main drivers of economic growth.

In its projections of macroeconomic indicators made this year, the European Commission (EC) pointed to the slow economic recovery in the EU. The unfavourable investment trends and the risk of a rapid spread of the public debt crisis resulted in a downgrade of most of the 2013 projections relating to the economic activity. In 2014 a gradual economic recovery is anticipated, accompanied by the necessary fiscal consolidation, lower inflation, a slight increase in the current account deficit, improved financial market conditions and an unchanged situation in the labour market, with a possible increase in structural unemployment which could threaten the potential growth.

2. Current Economic Developments and Prospects in 2013

Serbian economy in 2012 recorded GDP decline in real terms of 1.7% per annum as consequence of Euro zone and EU27 recession and decline of GVA of agriculture by 17.1%, construction by 7.5% and energy sector by 7.1%. Overal industry recorded annual decline of GVA by 0.3%, while services sector GVA increased by 2%. Main source of growth in 2012 in GDP expenditure side was government consumption (contribution of 0.4 pp), whie other components had negative contribution.

High inflation of 12.2% in Serbia in 2012 was generated by food prices growth in domestic and world market in preelection period. Inflation was driven by rising food prices (which accounted for one half of the figure) and increased administratively controlled prices. Other contributing factors to the high inflation included the increased general VAT rate and the deferred effects of national currency depreciation in the first half of the year. Low aggregate demand had a disinflation effect and that is also the case with the fiscal consolidation which began in Q4 2012. The curbing of inflation at the end of the year can also be attributed to the implementation of monetary policy measures.

A key result of the economic policies in 2013 is the recovery of the Serbian economy driven by growth in industrial and agricultural production and an increase in net exports. In the first six months of 2013, the economy has made - following the recession in the 2012 - a year-on-year growth of GDP in real terms of 1.4%, notwithstanding the deteriorating economic outlook in the eurozone and the countries of the region, as Serbia's key foreign trade partners. In Q3 2013 according to RSO flash estimation economic activity growth accelerated to 3.2% compared to Q3 2012 and by 1.1% deseasonalized.

Assuming the current macroeconomic trends and the planned economic and fiscal policy for the 2013, the estimated GDP growth in real terms will be 2%, inflation will increase by 5.5%[1], formal employment will decline by 0.9%, while all components of domestic demand will decrease in real terms due to lower investment and declining personal and government spending in real terms. At the same time, exports of goods and services are expected to grow at a rate of 14% in real terms, while imports of goods and services are expected to grow by 2.3% in real terms, with a reduction of the current account deficit to 6%[1] of GDP.

Economic recovery driven by growth in agriculture and industry and the increase in net exports was accompanied by a reduction of external and internal imbalances. Current account deficit as a share of GDP ratio will be significantly reduced due to the higher growth of exports over imports of goods with the prospect of reaching 6% of GDP at the end of 2013, as opposed to10.5% of GDP at the end of 2012. The increase in exports is attributable not only to the automotive industry but also to chemical, rubber and plastics industries, electrical equipment, etc., which have contributed significantly to reducing the current account deficit. Fiscal consolidation was a further contributing factor.

Sustainable economic growth and macroeconomic stability require continued fiscal and structural adjustment in the implementation of fiscal consolidation and structural reforms, contained and explained in chapter two and four of the Fiscal Strategy. In this context, the effects of fiscal measures and structural reforms on macroeconomic and fiscal aggregates and indicators will be monitored and the necessary additional measures on the revenue and expenditure side of public finance and further structural reforms will be undertaken.

[1] According to the actual estimation, NBS expects that inflation in 2013 will be around lower level of inflation target band, while the current account deficit will be 4-5% of GDP, as stated in chapter External sector and its sustainability.

Table 2 Estimation of key macroeconomic indicators for 2013 in %

GDP in billions of dinars (current prices)	**3,761.3**
GDP growth in real terms	2.0
Gross fixed capital formation, decrease in real terms	-3.4
Exports of goods and services, in EUR	16.5
Imports of goods and services, in EUR	3.3
The current account deficit (including grants)	-6.0
Inflation, end of period	5.5
Unemployment rate (population aged 15 +)	24.0

Source: MoF

The estimated GDP growth in 2013 was 2% above the average for South East Europe. Main contribution to economic growth in 2013 came from net export growth, while negative contribution will came from domestic demand, above all government consumption.

On the production side, GDP growth is estimated to be based on the estimated growth of GDP in agriculture of 18.6% and in industrial production by 3.3%, accounting for 1.7 pp and 0.7 pp of GDP growth respectively. The services sector will grow by 0.6% and contribute 0.4 pp to GDP growth, while the construction sector will record a decline of 18.5%, with a negative contribution of 0.7 percentage points to GVA growth. On the expenditure side, GDP growth in 2013 will be driven by net exports, with a contribution of 4.3 pp, while the contribution of personal, government and investment spending will be negative (-1.0%, -0.6% and -0.7%, respectively).

The estimated decline in gross fixed capital investments in 2013 will be 3.4%, given the large decline in construction activity and reduction of equipment imports in the first half of this year following the completion of the investment cycle in the automotive and oil industries. Repayment of corporate to foreign countries also contributed to the decline in private investment.

Decline in personal and government spending is largely due to the implementation of fiscal consolidation. Personal spending saw a decline of 1.2% in 2013. Recovery of private spending remains constrained by high unemployment and limited growth of public sector salaries and pensions as the main source of spending. Government spending and investment continued to decline in 2013 and contributed to a drop in domestic demand.

Net export is also the main driver of growth in 2013. The decline in domestic demand in 2013 is fully offset by an increase in net exports. Strong growth in net exports is the result of expansion in the automobile industry, and the growth in exports of petroleum products, pharmaceuticals and chemical products, and electrical machinery.

Inflation in 2013 will be within the target tolerance band. Monetary policy and fiscal consolidation measures, the stability of food prices, the relative stability of the foreign exchange market, low aggregate demand and stabilization of inflation expectations contributed to this.

In 2013 on the labour market it is expected that the unempolment rate according to the Labour Force Survey of around 24%, which is slightly below the level of unemployment in 2012 (24.6%).

3. Projection of macroeconomic indicators for the period 2014 – 2016

Based on current economic trends and outlooks for Serbia and the international environment, and taking into account the planned economic policies, the main economic aggregates and indicators have been projected for the Republic of Serbia in the period 2014-2016.

GDP projections and related indicators for the period 2014-2016 have been revised to a lower level, primarily due to the slow and uncertain recovery of the euro zone countries and the consequent slowdown in domestic exports, but also because of the severe fiscal policy measures that will act to reduce domestic demand of the households, particularly private consumption and government spending.

Macroeconomic projections for the period 2014-2016, indicate a slow path to recovery. The projected average GDP growth rate for the next three years of 1.6% is based primarily on the recovery of investment activity and growth in exports. Leading development factors such as the acceleration of export growth and investment, combined with the restructuring of the economy toward the tradable goods allow the creation of a solid base for sustainable economic growth with the reduction of internal and external macroeconomic imbalances.

Predicted cumulative real GDP growth of 4.9% over the next three years is based on the growth of investment and exports of goods and services at an average annual real rate of 7.7% and 7.1%, respectively, with average annual decline in personal consumption (-0.9%) and government spending (-3.4%). This will ensure an increase in productivity as well as changes in the economic structure toward increasing the share of industry and export in GDP.

Medium term Macroeconomic projection, estimate the increase in the share of investment to 22.7% of GDP, reducing the share of government spending in GDP to 16.4% and increase the share of exports of goods and services in GDP to 50.1% at the end of 2016. In addition, over the next three years, an increase of the share of domestic savings to GDP is predicted due to the growth of private savings . A net inflow of foreign investment of about EUR 1.6 billion a year on average is necessary, with a change in the structure of investment toward the sector of tradable goods. Financing the deficit suppose at the same time reducing the share of deficit of goods and services and the current account deficit (including grants) to GDP to the levels of 7.4% and 3.5% respectively at the end of 2016, so as to ensure the reduction of the absorption gap, sustainability of external debt, external liquidity and solvency.

Table 3 Projection of the main macroeconomic indicators of the Republic of Serbia

	estimation		projection	
	2013	2014	2015	2016
GDP, mill. RSD (current prices)	3,761,289	4,007,841	4,292,142	4,583,750
Real GDP growth	2.0	1.0	1.8	2.0
The real growth of the individual components of GDP , %				
Private consumption	-1.2	-1.8	-0.6	-0.3
Government consumption	-3.0	-2.2	-4.4	3.6
Investment	-3.4	4.7	9.6	8.9
Exports of goods and services	14.0	6.4	7.0	7.7
Imports of goods and services	2.3	1.6	3.5	4.6
The balance of goods and services, EUR, % of GDP	-11.9	-10.0	-8.6	-7.4
Inflation, end of period,%	5.5	5.5	5.0	4.5
Investment ratio , % of GDP	19.1	20.0	21.4	22.7

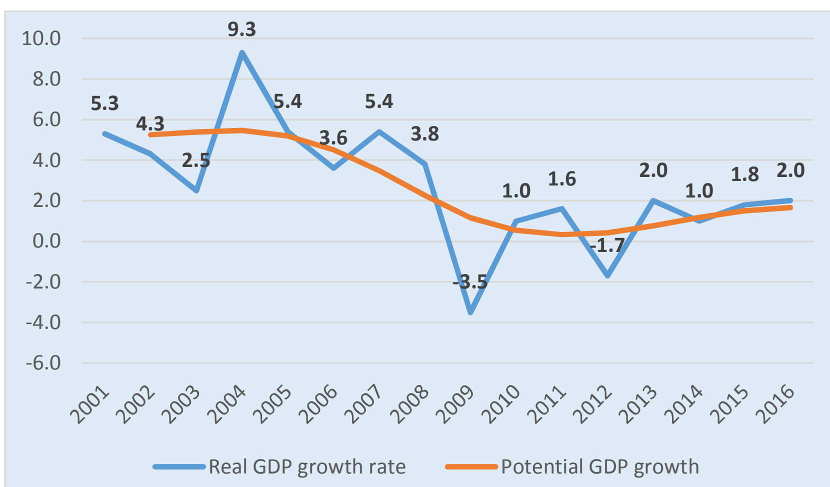
Source: MoF

The real sector

Midterm prospects for the real sector enable analysis of the cyclical position of the economy and consideration of the expected real GDP growth in terms of changes in the factors of production and aggregate demand.

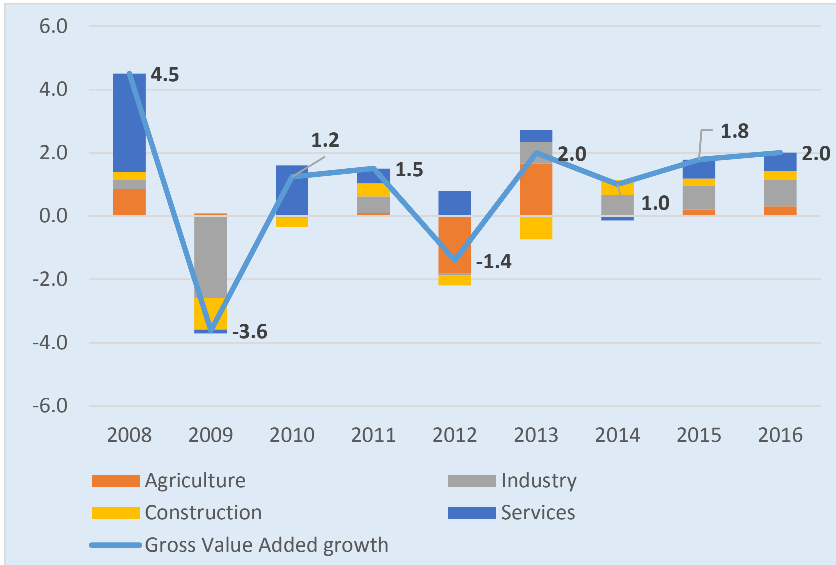
Medium-term macroeconomic projection envisaged real GDP growth in 2014 of 1.0%, due to the fiscal consolidation causing decline in personal consumption and government spending based on domestic demand. Moderate acceleration in GDP growth in 2015 and 2016 to 1.8% and 2.0% respectively is based on the growth in investment spending, especially in the private sector and growth of exports. The implementation of fiscal policy measures and improving the business and investment environment will provide a basis for building a stable and sustainable growth in the coming years.

Graph 1 Real GDP growth: actual rate and the long-term trend, in %



It is estimated that the potential GDP growth in the years to come will have positive influence on the strengthening of investment activity and to a lesser extent, to the growth in the participation rate. The expected increase in unemployment due to the completion of the restructuring under government control will be partially offset by a net increase in employment in the private sector. Also, it is estimated that the investment in fixed assets will make the largest contribution to potential growth rate in the next period, while the contribution of labor to the potential rate of GDP will be positive in the 2016.

Graph 2 Sectoral contributions to GVA growth activity, in percentage points

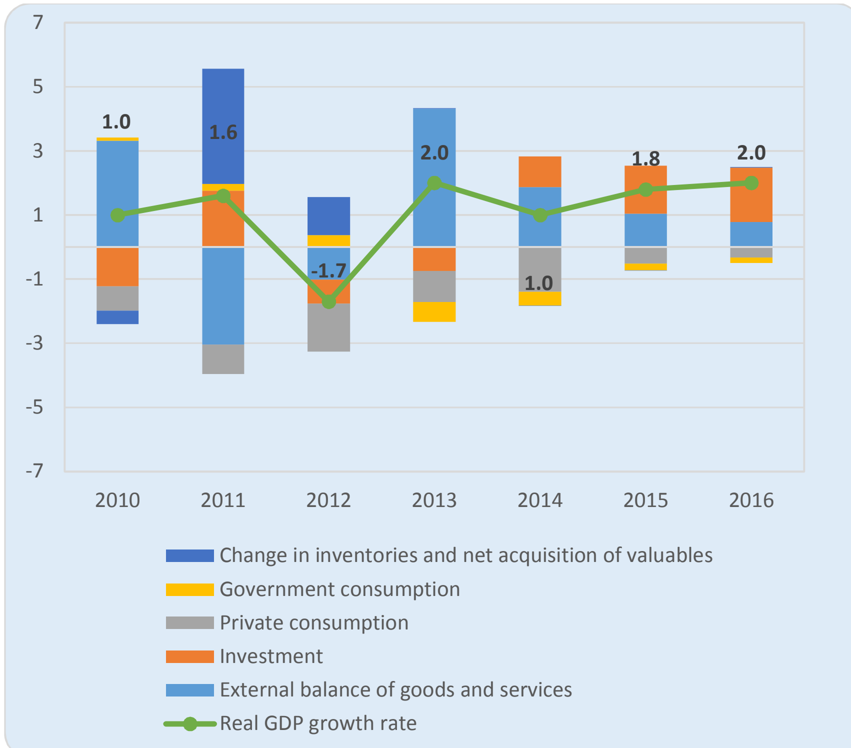


On the expenditure side of GDP in the period 2014-2016, the largest contribution is expected from investment spending (contributing 1.7 percentage points a year on average) and net exports (contribution 1.2 pp year on average). In the next three years, Government spending will continue to have negative impact to the GDP growth, primarily based on the limited wage growth of the Government sector (reducing administrative wages above certain thresholds), rationalizing headcount and implementation of other measures of the fiscal consolidation. Over the next three years the trend of reducing personal consumption of the population is projected to continue, given the limited disposable income and uncertain recovery of the labor market trends, as well as the indirect effects of fiscal consolidation (increased specific rate of VAT to 10%). Private consumption will give negative contribution to GDP growth over the next three years (-1.4 pp, -0.4 pp, -0.2 pp, respectively).

Macroeconomic forecast projected real investment growth from 4.7% in 2014 and 9.6% and 8.9% in 2015 and 2016 respectively, which will be generated by the new investment cycle. GDP growth in the next three years will significantly contribute to net exports (contribution of 1.9 pp in 2014, 1.0 pp in the 2015 and 0.8 pp in 2016). Strong export growth will continue in the coming years, while import growth will be generated by the growth of investment, and by the imports of capital goods and equipment.

The share of investment in GDP in 2014 is estimated at 20.0%, will grow in 2015 and 2016 to 21.4% and 22.7%, respectively, which will in conditions of a restrictive fiscal policy enable the realization of moderate economic growth rates and favorable labor market developments in 2016. The share of exports of goods and services in GDP in 2014 estimated at 44.7%, and in 2015 and 2016 to 47.1% and 50.1% respectively, represents a significant improvement compared to the previous period.

Graph 3 Contributions of categories of aggregate demand to real GDP growth, perentage points



Anticipated development scenario indicates that there are no opportunities for personal growth and government spending due to the strategic orientation towards the increase in investment and exports as key factors for achieving macroeconomic stability and sustainable economic growth. Also, the growth of investment is crucial, given that the decline in economic activity during the crisis, have reduced the potential impact on GDP through the loss of economic capacity and significant deterioration in the labor market conditions.

The basic rule of efficiency and growth through increased productivity, is firstly to use the existing capacity of the economy to produce higher quality and quantity of goods. Output gap, which measures the cyclical nature of economic activity during the transition period was negative, with the exception in 2007 and 2008 (1.8% and 3.4%, respectively) driven primarily by high domestic demand. In 2009 due to the economic downturn the negative output gap has deepened, which is continued in the following years. Slowing growth in productive potential of the economy is a result primarily of reduced investment in production capacity, difficulties in financing current production activities of the company and the negative trends in the labor market.

Projections of potential growth for the period 2014-2016 is based on the gradual economic recovery, with the output gap that is expected to be closed in 2015, after years of negative relationship between actual and potential GDP growth .

Particular concern will be finding ways to increase total factor productivity which has recently declined, primarily as a result of declining investment efficiency, given the current cyclical position of Serbia and structural distortions inherited from the previous period and the extent of existing unused capacity. For this purpose, it is necessary to carry out structural reforms to ensure country's long-term sustainable development on the basis of higher productivity in the economy.

In pursuing the development of screening risk of slower growth in investment spending by the private sector, the planned growth and a lower inflow of foreign capital than planned, which is the biggest risk to the dynamics of investment activities in the future.

Employment and Wages

It is expected that the total employment will slow down the decline in 2014 and 2015, after a sharp decline in recent years, while in 2016 is expected a slight increase in employment in the private sector. Midterm employment projections are based on the projected GDP growth and increasing investment. Also, projections of employment include the effect of completion of the restructuring under state control, in accordance with the adopted Action Plan of the Government. At the same time, formation of trend of increasing employment rates is expected due to increased investment in job creation in the private sector. Reform of the legal framework of the labor market is particularly important for productive employment in the future, primarily by removing barriers to employment by reducing labor costs in order to increase the employment rate, reduce employment in the gray zone and increase the competitiveness of the economy.

In the next period, slower growth in real net wage growth of real GDP is expected , and the growth of gross earnings in accordance with productivity growth in the private sector, which will result in reduction of unit labor costs and enhance the competitive position of the country.

Inflation projection

Absent any major shocks in the coming period, inflation is expected to move within the target tolerance band. The fall in primary agricultural commodity prices in the previous agricultural season and the consequent decline in food prices in late 2013 and early 2014 (despite the January revision of the VAT rate from 8% to 10%) will probably keep y-o-y inflation in H1 2014 below the targeted 4%. Once the new agricultural season kicks in and agricultural prices edge up in H2, inflation will rise steadily towards the target. At the same time, the completion of the six-year process of lowering customs duties on imports of food (and other) products from the EU in early 2014 is expected to make food prices in the coming years significantly less volatile than so far.

At the same time, consistent implementation of fiscal consolidation measures and a further narrowing of external imbalance should ensure relative stability of the exchange rate of the dinar against the euro. It should also be noted that the short-term pass-through effect from the exchange rate to prices has weakened considerably over the past several years, which lessens potential inflation volatility on this account.

Considering the planned fiscal consolidation, high unemployment, weak lending activity and the still insufficiently fast recovery of the global economy, aggregate demand will be probably producing a disinflationary effect in the next three years as well.

In H2 2013, inflation expectations recorded a sharp fall, but stayed above the targeted 4%. We expect they will be gradually anchored to the target over the coming years, which will contribute to the stabilisation of prices.

Administered prices, on the other hand, will be rising in the coming years much faster than other prices as they are still relatively underestimated, i.e. do not cover the cost of production. Over the next three years, these prices will be adding 1.5–2.0 pp to headline inflation.

The risks to the projected inflation path are associated chiefly with developments in the international environment, or more specifically economic policy and developments in advanced countries, as well as with the success of fiscal consolidation at home.

Monetary policy and exchange rate

Based on macroeconomic projections the NBS Executive Board has set the inflation targets until end-2016 at 4% with a target tolerance band of ±1.5 pp. The inflation target remains above the quantitative definition of price stability and inflation targets of advanced economies (2.0% or 2.5%) because Serbia needs to remove price disparities, particularly in the area of administered prices.

The NBS will strive to achieve the inflation target by using its key monetary policy instrument – the interest rate applied in its one-week reverse repo operations. This interest rate will be adjusted in a consistent and predictable manner, in line with economic developments and inflation projection. In addition, the NBS will use all other instruments under its remit to achieve the medium-term inflation target, but these instruments will have a supporting role (longer-term open market operations, reserve requirements, interventions in the interbank foreign exchange market, etc.). Supporting instruments should contribute to the smooth pass-through of changes in the key policy rate to inflation and economic activity, as well as to the development of financial markets, without jeopardising the stability of the financial system.

The NBS will allow inflation to deviate temporarily from the target if bringing inflation back to the target in the short term requires changes in monetary policy that could cause additional macroeconomic instability. This applies in particular to sudden changes in primary commodity prices or to prices under the Government's direct or indirect control.

In its efforts to achieve the inflation target, the NBS will act transparently and with full responsibility towards the public. It will inform the public regularly, primarily by its Inflation Report, on the achievement of the inflation target, on expected inflation and the underlying macroeconomic movements, as well as on the monetary policy measures that need to be taken in order to ensure the achievement of the target in the future. Should the actual inflation rate depart from the target for longer than six consecutive months, the NBS is obligated to inform the Government in writing about the reasons for such departure and propose the measures and time needed to bring inflation back to the target.

The NBS will continue to implement the managed floating exchange rate regime, which means that it will intervene in the foreign exchange market: 1) to mitigate significant short-term volatility of the exchange rate in either direction, but without influencing the exchange rate trend, 2) to contain threats to price and financial stability, and 3) to safeguard an adequate level of foreign exchange reserves.

Looking ahead, monetary policy measures will continue to be geared at achieving the inflation target (4±1.5%). The monetary policy stance will depend primarily on developments in the international environment, but also on the pace and scope of fiscal consolidation at home, given that inflationary pressures from other sources have subsided significantly. Monetary policy easing is likely to be continued if no major external shocks erupt and if fiscal consolidation measures are implemented as planned. The anchoring of inflation expectations to the target would open the space for additional monetary policy relaxation.

No major pressures on the exchange rate are likely in the period ahead given the expected consistent implementation of fiscal consolidation measures, as well as further narrowing of the external imbalance and improved economic performance of the euro area as our key trading partner. The latter should also lead to FDI growth in Serbia. Potential QE tapering by the Fed and an unfavourable turn of events in terms of financial stability of the euro area could affect the flow of capital to the Republic of Serbia and send pressure on the exchange rate. However, a credible implementation of the fiscal adjustment measures would by all means moderate the potential spill-over of these effects onto the domestic financial market.

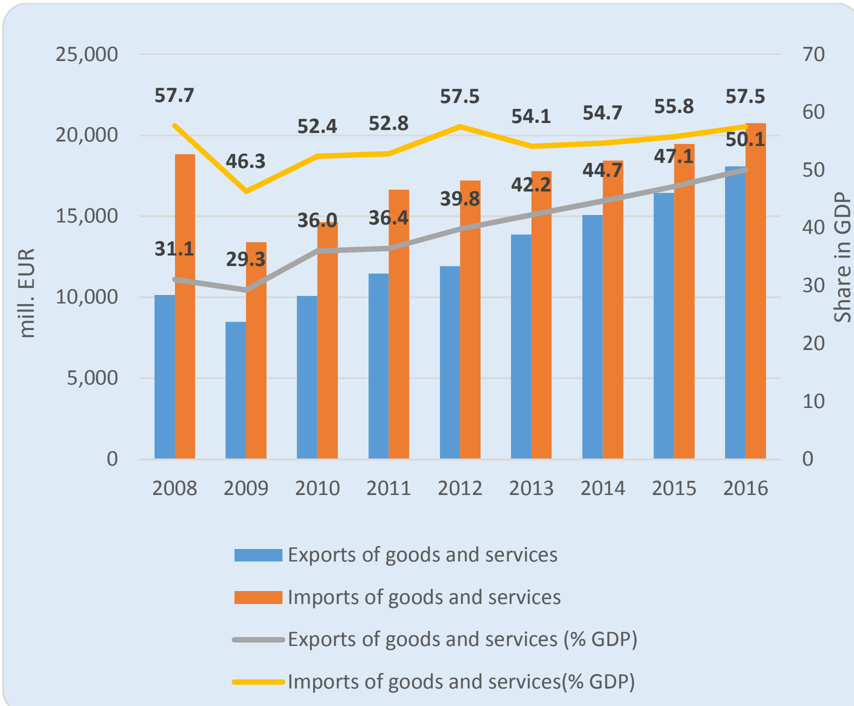
Projected balance of payments

The key to the sustainability of the balance of payments is to increase exports and net foreign capital inflow. Macroeconomic projection envisages strengthening exports and foreign investments in in 2014 and in the next two years. A precondition for significant export growth is implementation of structural reforms and strengthening of cost and price competitiveness. This would increase the share of Serbian exports in the world market. In addition to goods trade, the exchange of services as well could improve the current account balance.

Medium and long-term sustainability of the current account balance will depend on the implementation of structural reforms and increasing competitiveness of exports of goods and services. As the sustainability of the balance of payments position requires a moderate increase in interest–related expenses, in the case of drastic deterioration in financing conditions in international markets makes a substantial pressure on the re-growth of the current account deficit. In this respect. important role belongs to sustaining the fiscal position and financing conditions in the international capital market. It is expected that the effects of fiscal consolidation by reducing unproductive government spending would continue to influence to the decreasing of the current account deficit in future.

In the period 2014-2016 relatively high rate of exports growth are expected (9.2%) and moderate growth of imports (5.3% on yearly basis, average), in EUR terms. The biggest share of imports will be orientated toward import of capital and intermediate products targeting intensifying of the investment activity. Faster pace of growth of the export that the import's one, will mean reduction of the trade deficit of goods and services at the level of 7.4% of GDP in 2016. Lower level of the current account deficit (with the grants) is expected at the end of 2016 share of 3.5% in the GDP. Reduction of negative net export of goods and services will be a result of a structural change in the economy and it will contribute to the decrease in the external imbalance and to the risk of external debt sustainability and external liquidity.

Graph 4 Exports and imports of goods and services

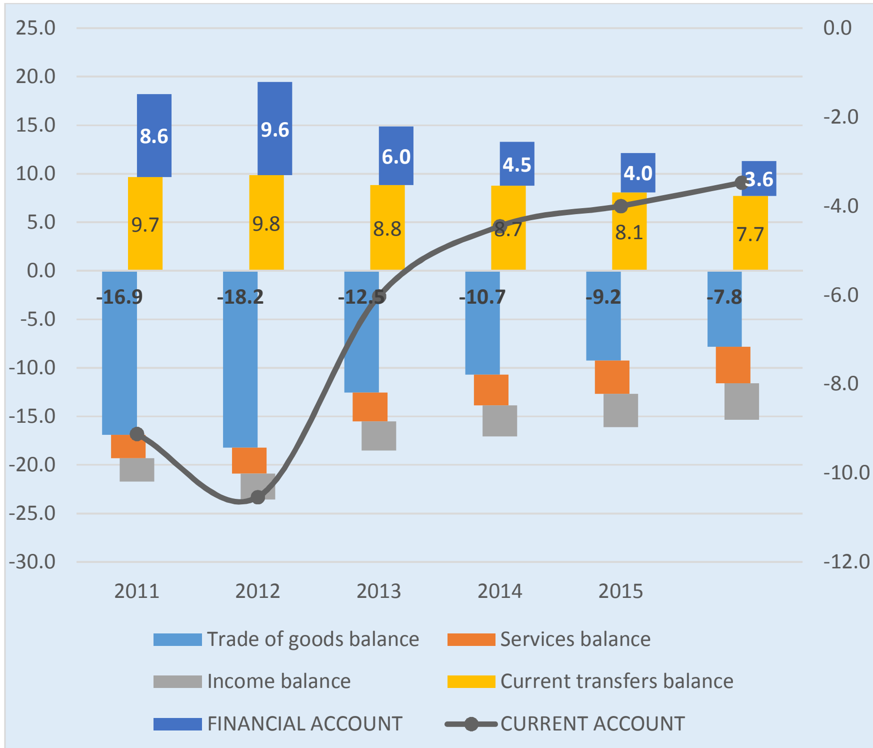


In the next three years period inflow to the current account is expected on the current transfers basis, but from the factor payments outflow. The most important category in the current transfers are remittances, while the biggest share in the factor payments has interest paid on the external debts. It is estimated that the net current transfers with non-interest incomes on the basics of factor payments will be at the level of EUR 3.0 billion in the period 2014-2016. Also, it is expected negative balance of non-interest payments of EUR 1.3 billion. Net effect of the current transfers will be positive and stable in the next three years period amounting EUR 1.0 billion per years. Surplus of the current transfers balance and net factor payments will cover 55% of the external trade deficit u the period of 2014-2016.

On the basics of the expectations related to the balance of the external trade, current transfers and net factor incomes projections of the current account balance have been made. Balance of the current transfers will be negative in the period 2014-2016, with a value of EUR 1.4 billion, average on the yearly basis. At the same time, in the structure of the capital inflow, share of the foreign direct investments will have dominant role in the financing the deficit of the current account amounting EUR 1.6

billion in 2015 and 2016, respectively. Besides the foreign direct investments, the current account deficit will be covered by the external credits to.

Graph 5 The current account deficit and its financing, % of GDP



In the period 2014-2015, it is forecasted that the amount of the Serbia's external debt will be stabilized at the level of 85% of the GDP. It is also forecasted that the share of the debt payments in the GDP and exports will be gradually reduced, while the share of the interest rates will slightly increase.

According to the estimation, NBS foreign exchange reserves in the period 2014-2016 will cover the value equivalent to the value of eight month export.

External sector and its medium-term sustainability

External imbalance narrowed down significantly in the course of 2013 the share of current account deficit in GDP was cut from 10.5% in 2012 to around 4-5% in 2013, thanks to significantly faster growth in exports than in imports. As a result, the export to import cover ratio climbed to around 70%[2] and the degree of openness of the Serbian economy, measured as the share of trade in GDP, reached 100%.

The share of exports to the EU increased to 63.0%, while the share of exports to CEFTA countries and Russia contracted to 18.7% and 7.3%, respectively. The structure of exports improved significantly reflecting vibrant exports of automobiles, miscellaneous electrical machines and parts and chemical products, stable exports of rubber and plastic products, clothing and footwear and a slower pace of exports of

[2] 12-month moving average

lower value added products. Though automobiles account for more than 13% of the total value of exports, the share of other higher value added products is also rising. Furthermore, our export offer has been supplemented with around 200 new products.

Over the next three years, we expect the foreign trade deficit to fall further down to below 10% of GDP, on the back of continuing export expansion of the automobile and related industries, growing oil industry output (substitution of imports) and fiscal consolidation measures. Due to the fiscal adjustment, the expected savings on imports will be largely offset by increased interest payments on the external portion of public debt (loans and securities). Based on the experience of other countries, we expect that the repatriation of profits generated by non-residents' direct investments will have a more important effect on the income account in the future. After declining somewhat in 2012, remittances rose to around EUR 3 billion in 2013. The inflow of remittances is expected to continue at a stable rate in the coming period as well. This should lead to a further drop in the share of the current account deficit in GDP to around 3–4% in the period 2014–2016.

Price competitiveness of the Republic of Serbia deteriorated somewhat in the course of 2013 – in the year to September real effective exchange rate of the dinar appreciated by 0.8% against the euro and the dollar[3] and by 2.2% against the currencies of 35 most important trade partners of the Republic of Serbia[4]. Still, relative stability of the nominal exchange rate in H2 2013, plus a smaller gap between domestic and foreign inflation, brought the appreciation trend of the real exchange rate to a halt. As indicated by the movements of the real exchange rate of the euro calculated based on unit labour costs[5], external cost competitiveness of the Republic of Serbia stagnated in H1 2013 since nominal appreciation of the exchange rate was neutralised by the lower growth in unit labour costs in Serbia relative to the euro area. The fall in domestic unit labour costs since early 2013 was driven by a faster growth in productivity relative to gross wages. Supressed inflationary pressures and stable movements in the foreign exchange market should underpin more stable movements of the real effective exchange rate in the coming period, i.e. they should halt deterioration of the external price competitiveness of the Republic of Serbia. This should also have a positive effect on export expansion, which began in late 2012, and on further reduction of the external imbalance.

The main risk to the country's external solvency is the high share of total external debt within the international investment position (IIP) in GDP which ended 2013 just shy of 100%. Foreign financial assets declined, while foreign financial liabilities rose reflecting chiefly the increase in the negative IIP of the public sector. Banking and other sectors also had a negative IIP. Functional breakdown shows that the negative IIP increased on account of FDIs and portfolio investments in respect of issuing RS Eurobonds, while it decreased on account of financial loans. Foreign exchange reserves cover the negative IIP of domestic sectors by around 25%, which implies a

[3] Currency basket consists of EUR and USD in ratio 80:20.
[4] In this case average share of EUR amounts to 51% while USD 3.5%.
[5] Calculated as a product of nominal exchange rate of RSD against EUR and ratio of unit labour costs of overall Serbian economy and Euro zone.

satisfactory external liquidity of the country – in September 2013 the coverage of short-term debt at remaining maturity by foreign exchange reserves was 237.9% and that of imports, 7 months.

The negative IIP of the private sector is expected to increase as of 2014, mainly as a result of the anticipated higher FDI inflow (projected at more than EUR 1 billion a year over the next two-three years). FDI inflow should be aided by the recovery of the euro area and by Serbia's progress in the EU accession process. Increased government borrowing in the international capital market will at the same time push up the negative IIP of the public sector, which is nonetheless expected to go down as of 2015 or 2016 as a result of consistent implementation of the fiscal consolidation programme.

Looking ahead, the scope for reducing the external imbalance further will largely depend on foreign demand, that is on the pace of recovery of the euro area and our key trade partners, as well as on the access to external financing given that the announced FED quantitative easing tapering will probably lead to lower liquidity in the international money market, and on the effects of fiscal consolidation at home. A prerequisite for a major rise in exports is to increase their competitiveness (by lowering the costs and risks of business start-up and investment in Serbia and by cutting the red tape). If we fail in this effort, our share in global exports is not likely to expand. The factors that also play an important role in boosting the volume of foreign trade include progress on the path to the EU, intensification of economic cooperation with CEFTA members, finalising negotiations with the WTO and improving the investment climate so as to attract foreign investors in tradable sectors.

Financial sector

As in the previous years, the Serbian financial sector is expected to stay stable and resilient to the key risks in the system. High capital adequacy and liquidity ratios are expected to be maintained. As regards liabilities, the Serbian banking sector is poised for continuing domination of deposits in bank funding and further reliance on the domestic sources of finance.

A sustainable recovery of lending activity to the corporate sector will come about only once the economic recovery takes hold.

As regards the key risks in the system, the upward trend in the share of dinar deposits in total household deposits is expected to continue, thus contributing to the greater level of deposit dinarisation. These trends will be aided by the stable exchange rate of the dinar and by the lower inflation rate.

Together with the decline in the dinar money market interest rates, the achieved stability of the exchange rate of the dinar and lower inflation rate can help prevent further accumulation of NPLs. Still, considering the root causes of this problem, it is fair to say that the issue of high NPLs will be resolved on a long-term basis only once domestic and foreign demand recover and the effects of the planned structural reforms come to the fore.

Profitability of the banking sector is expected to improve further in response to the sector's consolidation in 2012 and 2013. Still, the profitability of the banking sector will also hinge on the recovery of economic activity and overall lending.

Banking sector regulations will be further aligned with the relevant EU regulations. The NBS is currently considering the most suitable manner and timeframe for Basel III implementation in accordance with the EU legislation implementing those Basel standards. By the end of 2013, the NBS will adopt the Strategy for Implementation of Basel III Standards in Serbia. Pursuant to the National Programme for the Adoption of the Acquis 2013–2016, the NBS will adopt regulations harmonised with Basel III as envisaged by the CRR and CRD IV in the period 2014–2016. The implementation of Basel III standards should not have a major impact on the business models of banks operating in Serbia, even though they are likely to exercise more caution in managing their capital levels. Before amending the regulations, the NBS will assess the impact of the introduction of new standards on the capital adequacy and liquidity of individual banks and the banking sector as a whole in order to draw up an appropriate plan of implementation.

4. Main Objectives of Economic and Fiscal Policy

The Government's economic policy in the next medium-term period will be focused on ensuring sustainable economic and financial stability, curbing debt and creating an environment conductive to economic growth.

A new model of Serbia's development will be based on cuts to wasteful spending, red tape and unnecessary state spending, coupled with increasing investment spending to boost economic growth and employment, while at the same time providing social security to the most vulnerable sections of society. A pivotal role in this will be played by fiscal policy and structural reforms with defined short, medium and long-term measures agreed between the social partners (the government, trade unions and employers) and supported by the general public, the relevant industries and the international community.

In early October 2013, the Government adopted a package of measures to stabilise public finances and speed up economic recovery. Strengthening of the economy requires consolidation of public finances and implementation of a fiscal policy based on the principles of responsible fiscal management and fiscal rules that introduce stricter fiscal discipline, improve fiscal coordination between different levels of government, reduce fiscal risks and ensure long-term fiscal sustainability.

In parallel with this, it is necessary to stimulate the growth of those parts of the economy that contribute to GDP growth, exports and employment. Granting of subsidised loans will be continued, albeit on a smaller scale, primarily for new investment and new employment; however, most – if not all – of it will be done in partnership with commercial banks and private institutions. A higher inflow of foreign investment is expected after the introduction of fiscal consolidation measures and the commencement of structural reforms to improve the business environment and increase public sector efficiency. This will provide the basis for optimal economic restructuring and cutting the state's involvement in the economy to a minimum. The goal is to kick-start the economy and reduce unemployment through job creation in the private sector and to build on that basis to achieve a higher standard of living.

Efforts to boost the economy will be focused on creating a stimulating business environment for entrepreneurs and investors and facilitating their operations. The remaining economic reforms will be expedited to improve the business environment, in particular through strengthening the rule of law and eliminating unflexible labour market conditions. The aim is to put in place structural reforms in order to create a business environment that will be conductive to growth of domestic and foreign investment, faster economic restructuring and higher productivity and competitiveness. For this purpose, relevant amendments will be made to the Labour Law, the Bankruptcy Law, the Privatisation Law, the Law on Planning and Construction and other laws.

Economic policy in the coming years will be based on Serbia's comparative advantages, primarily in the fields of agriculture and food industry, energy, transport infrastructure, automobile industry and information technologies. To develop the sectors that drive the economy, we intend to foster a business environment conductive to investment in these fields and in the industries that will start a new cycle of investment and development. A favourable investment climate will give Serbian and foreign investors assurances of legal certainty and provide incentives for basing their production and investment in Serbia rather than its neighbours. To that end, measures will be taken to ensure exchange rate stability, lower cost of capital and more efficient administrative procedures.

The following will be paramount for economic growth and a higher volume of investment: (1) creation of a stable and predictable business environment by introducing appropriate legislation, including in particular that relating to the Labour Law and the Law on Planning and Construction, coupled with intensified efforts to complete the "legislative guillotine" and to introduce e-government; (2) completion of privatisation of the remaining enterprises through restructuring and bankruptcy proceedings according to the specified timeframe, supported by improved privatisation and bankruptcy legislation; (3) professionalisation of management in public enterprises and introduction of responsible corporate governance in those enterprises that will remain under state control, coupled with the transfer of social policy responsibilities from the public enterprises to the social security system, (4) introduction of a stimulatory tax policy that fosters economic activity and employment, (5) a gradual and responsible withdrawal of the state from the economy, including a transition to models of concession financing and public-private partnerships whenever economically feasible and justifiable, and (6) a zero-tolerance policy on non-compliance with the law and on crime and corruption, which will be implemented by reformed institutions of the system.

In order to achieve macroeconomic stability and ensure economic growth in the next three years, the Government will change the way that the fiscal policy is conducted. This will imply the adoption and implementation of a credible fiscal consolidation programme that will reduce fiscal deficit and stabilise general government debt till 2016.

The main objectives and priorities of fiscal policy in the coming period include:

- Reducing public expenditure, fiscal deficit and public debt as a share of GDP;
- Clear prioritisation of capital/investment projects in which the state will act as an investor and a shift in other projects of this kind towards the model of concession financing and public-private partnerships;
- More stringent tax discipline, which implies higher tax collection rates and reduced share of the informal economy;
- Consideration of possible avenues for shifting the focus of tax policy from payroll taxes to other forms of tax revenue in the medium term, while ensuring that any such arrangement ensures with absolute certainty there is no ultimate effect on the bottom line;
- Strengthening long-term fiscal sustainability through the implementation of structural reforms, in particular public sector reforms.

The achievement of fiscal policy objectives and priorities will depend on the pace of fiscal consolidation measures and key structural reforms in the forthcoming period, which are dealt with in detail in chapters 2 and 4 of the Fiscal Strategy.

Fiscal policy in the next three years will be based on fiscal consolidation, given the increasing fiscal deficit and public debt and increased cost of finance. To this end, fiscal consolidation measures, measures to combat the informal economy and other scheduled public sector reforms will be implemented. In this context, the pace of fiscal consolidation should be adjusted so as not to undo the positive effects of the ongoing investment cycle or shift the current trend in the economic activity. As regards efforts to cut budget expenses, efforts will be focused on preserving the sources of potential growth and improving the efficiency of public spending. Fiscal policy measures will therefore be aimed at fiscal consolidation, which has a positive effect on economic growth and operates within the accepted fiscal rules and adjustments on the revenue and expenditure sides of the budget, thus resulting in lower fiscal deficit.

The principal commitment of medium-term fiscal policy is to achieve fiscal adjustment – a step necessary to curb public debt – primarily by increasing revenues, which is expected to be achieved through efforts to eliminate the informal economy, reduce public spending as a share of GDP and increase economic activity due to structural reforms and changes in the model of capital investment financing. A key role in fiscal sustainability in the medium term will be played by structural reforms in the bloated and inefficient public sector, including enterprises with state-owned equity.

The next three years will see the implementation of fiscal consolidation measures which will result in lower fiscal deficit, which in turn will also reduce public debt.

On the revenue side, additional inflows are anticipated from: systematic elimination of the informal economy; pro-rata cuts in public sector salaries above certain thresholds (RSD 60,000 and 100,000 net); increasing the special value added tax (VAT) rate from 8% to 10%, coupled with the imposition of the general VAT rate on some of the non-essential goods hitherto taxed at the special rate; improved collection of excise duty charged on tobacco by preventing illegal trade in tobacco and manufactured tobacco and the revocation of corporate income tax relief.

On the expenditure side, the following additional key measures have been envisaged: restrictive indexation of public sector salaries and pensions; scrutiny and limitation of performance-related bonuses in the public sector; lower subsidies from the central government budget and local government budgets as a result of a revision of the existing subsidy programmes; lower expenditure for goods and services achieved through rationalisation and more effective control of procurement; reduction of interest expenses payable on expensive public debt servicing by substituting it with cheaper available alternatives; and increased social expenditures due to an increasing number of social welfare recipients and the amounts paid for family support.

The envisaged fiscal adjustment will for the most part be achieved through measures that will contribute to lower current public spending. The growth of public sector salaries and pensions – as the largest contributors to public spending – will be curbed by a restrictive indexation of salaries and pensions, which will gradually bring about to a reduction of these expenditures as a share of GDP. The remaining portion of the necessary fiscal adjustment will be achieved through cuts in discretionary spending, including in particular subsidies and budget loans. To achieve the required level of fiscal adjustment, austerity measures will be put in place across all levels of government, including both central and local; public procurement procedures will become more efficient; and economic support measures will be redefined, in an effort to channel the limited amount available for incentives into those economic support programmes that yield the best results.

As regards public investment, given the limited scope for capital investment, it will be necessary to prioritise taking into account the limited resources available and the need to invest in those projects that give the best social cost-to-benefit ratio. In addition, wherever possible, models of concession financing and public-private partnerships will be considered wherever feasible.

The NBS will support the implementation of the Government's economic and fiscal policies through monetary policy measures and instruments, taking care not to jeopardize the achievement of the core objectives of monetary policy in terms of price stability and stability of the financial system.

5. Risks for the realization of projection and Alternative Scenario of growth

The fiscal strategy in this section shows the main external and internal risks for achieving the envisaged macroeconomic scenario.

Key external risks for this projection are primarily related to uncertainty in the global economic recovery, particularly in the euro zone economy. The global economic recovery is slowing down, with significant differences in growth rates among groups of countries. The economies of the U.S. and Germany achieved positive growth rates with indication of possible slowing down in future, while the EU economy is stagnating while the euro zone is in recession. Increased risk in terms of recovery of the global and European economies, which significantly affects the recovery of the countries in the region, contributes greatly to the uncertain outcome of the economic and political crisis in the EU regarding the euro crisis.

Adverse trends in the EU slow down growth and exports in Central and Eastern European countries because of reduced demand for exports and reduced capital inflows, as well as increase of the cost of borrowing. Serbia's economic recovery will largely depend on the recovery of the euro zone economies and the economies in the region, increase in foreign demand and foreign capital inflows, foreign interest rate movements, movements in import prices, food prices and the prices of petroleum products. Projected growth rates will largely be depended on the intensity of the crisis in the euro zone and deterioration of the foreign banks situated in the country with the situation in its parent branches. In addition, raise of the commodity prices or worsening financing conditions would have a negative impact on projected rate of growth.

Internal risks for this projection are related to the delay of economic reforms implementation and economic policies, as well as a sudden changes in aggregate demand, accelerating inflation, higher volatility of the dinar against the euro, thus increasing the foreign exchange market disturbances, deterioration of the investment climate, reducing the inflow of foreign direct investment, an increase in the risk premium on foreign loans to domestic enterprises, political and other risks.

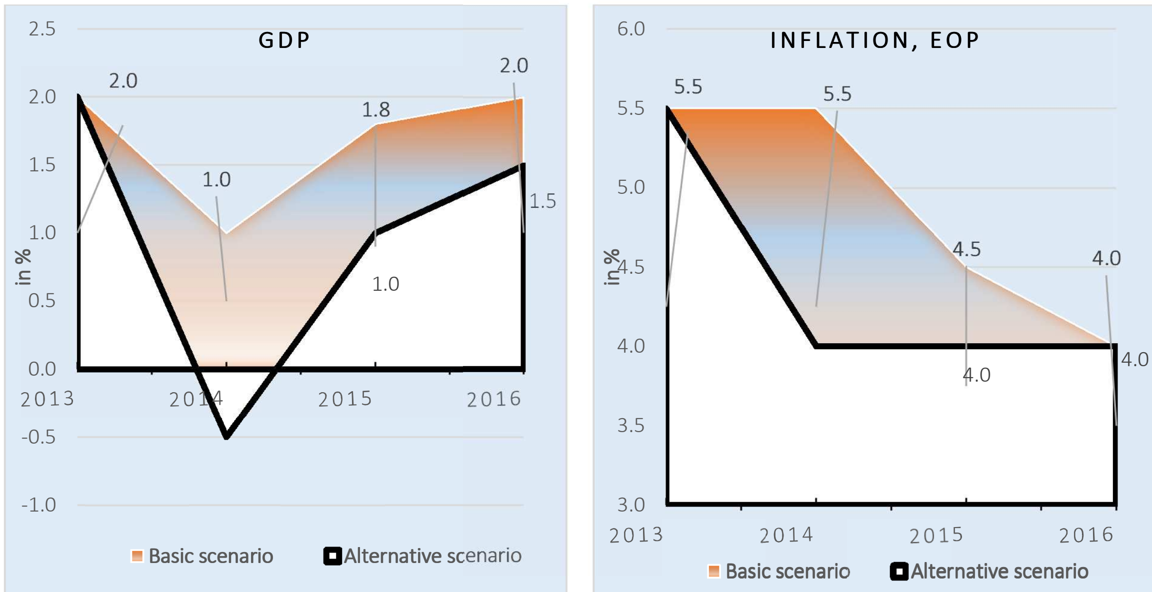
Given the pronounced internal risks in achieving macroeconomic projections in 2014 and the next two years, there is an alternative scenario with lower economic growth in the medium term compared to the baseline scenario are presented with moderate economic growth.

An alternative scenario is based on the key assumption that in the next three years there is a risk of slower growth in domestic demand, particularly investment spending as a driver of economic activity, and the private consumption of the households. Added to this, there is present an internal risk associated with delay and slow structural reforms planned for the midterm due to which the absent significant effects of reforms to stabilize the public finances and the acceleration of economic growth would be missing. Economic activity would be adversely affected also by external risks associated with slower recovery of the EU 28 and countries in the region that would significantly reduce export demand and capital inflows as the main drivers of growth.

Starting from the assumptions underlying the alternative scenario, the average annual growth rate of 0.7% of real GDP in the period 2014-2016 is projected, provided that the rate of GDP growth in 2014 is negative (-0.5%). Slow path of recovery of Serbian economy is demonstrated also by low cumulative real GDP growth of 2.0%.

Predicted average and cumulative real GDP growth is based on the real growth of exports of goods and services at an average annual rate of 5.7 % and real growth in investment in fixed assets at an average annual rate of 3.0%. In addition, personal and government spending in real terms would drop, while the main contribution to GDP growth in the next three years would be given by net exports (1.4 pp).

Graph 6 An alternative scenario



According to an alternative scenario, all sectors of the economy in 2014 contribute negatively to GDP, except for the industrial sector (contribution 0.1 pp). In 2015 and 2016, industry and construction would give a positive contribution to GDP growth of 0,4 and 0.9 pp, respectively, due to the slight increase in economic activity in these sectors.

Projected decline in GDP in 2014 and low rates of growth in 2015 and 2016 were based on the assumption of slowdown in investment spending and lower inflows of foreign capital, compared to the baseline growth scenario representing the highest risk of primary and alternative scenario.

The main risk of primary and alternative growth scenario is related to the slower growth of domestic demand than expected.

Within the structure of GDP, because of targeting investment and net exports as an engine of growth , there is no room for the growth of private consumption and government consumption . In the final demand for the next three years a drop in personal spending and the decline in government spending is envisaged, which will have a negative impact on economic activity and government revenues.

Foreign trade and balance of payments of the country in the alternative scenario, have less favorable performance due to lower real growth rate of exports of goods and services (5.7% on average per year) and other adverse developments in the external sector. Import would record low average real growth rate of 2%, which could cause a reduction in the trade and current account deficit at the end of 2016 at -6.7% of GDP and -3.0% of GDP respectively.

External debt sustainability and external liquidity pose the greatest risk to the sustainability in primary and alternate scenario. The main point of risk in financing of the balance of payments and the remaining investments is the high rate of debt service in an alternative scenario. Also projected is a lower net inflow of foreign direct investments than in the baseline scenario, which would negatively impact the funding of the balance of payments deficit.

Achieving lower real GDP growth rates predicted in the alternative scenario will cause an increase in the unemployment rate in 2014 to 25.3%, which would be followed by slight decrease to 25.2% in the 2015 and to 24.5% in the 2016. Projected trends in economic activity and investments over the next three years, according to an alternative scenario, do not allow for an increase in employment, especially in 2014, primarily due to redundancies in the process of restructuring the portfolio of the Agency for privatization and restructuring of public enterprises and rationalization of the number of employees in the government sector.

The inflation - in the alternative scenario – is projected at 4% per annum over the next three years, given low aggregate demand, fiscal consolidation, which has a disinflationary effect, lower pressures on food prices, better control of the movement of regulated prices, relative stability of the exchange rate and lower import prices.

III. Fiscal Framework for the period 2014 – 2016

1. Medium-term Fiscal Policy Objectives

The objective of fiscal policy in the medium term is to slow down the public debt growth, at first, and then enable its relative decrease, in the long run that is, lowering of debt to GDP ratio to around 45%, in line with the overall fiscal rule.

General government public debt has doubled in the past few years, so that it is estimated that by the end of 2013 it will stand at around 64.2% of GDP. Increase in the debt stock in this year was due to larger deficit, but also because of increased guarantees issued, in accordance with the revised budget.

Further delay to limit the growth of debt brings into question the sustainability of public finances and the possibility of financing expenditures, especially such expenditures as salaries, pensions and social benefits paid from the budget, which are legally binding and which amount to more than 80% of total public spending. Increase in the deficit is the result of drastically lower income compared to the initial planned budget revenues by as much as 3.0% of GDP, so that the deficit would have been at the level of the previous year if the revised budget expenditures had not been reduced by 1.0% of GDP in net terms.

Fiscal consolidation measures implemented since 2012, on the revenue side, have not yielded the expected results. Despite the significant increase in tax rates (VAT, CIT), aggregate demand has reduced as a consequence of the fall in real household income (salaries, pensions and other forms of social assistance), while, at the same time, there was a growth of the informal economy and illegal trade (particularly shredded tobacco). Stabilization of the debt in the next period will concentrate on the reduction of the deficit, strict control of the new guarantees issued and granting new project loans to finance major investment projects in road, rail and gas infrastructure, agriculture, energy, etc. On the other hand, privatization revenues and lease of state property, as well as soft loans will be used for the refinancing of more expensive debt, so that in the future they will reduce the overall cost of debt service (interest and principal).

Deficit reduction will be largely based on the adjustment of expenditure. Expenditures policy will be executed in accordance with the special fiscal rules related to indexation of salaries and pensions, and further lowering the level of other expenditures, particularly subsidies for enterpirses and net lending, based on the expected completion of the restructuring and privatization of state owned enterprises and socially owned enterprises. Medium-term fiscal framework, including the proposed fiscal consolidation measures is expected to provide a significant reduction of the general government deficit at the level of 2.3% of GDP (3.2% augmented fiscal deficit) by 2016, along with the public debt level stabilization (Table 17). This implies a cumulative adjustment in the deficit from 5.4% of GDP including the expenditures that appear “below the line" (augmented deficit). If we look at consolidation level without financial transactions “below the line", then the cumulative adjustment of the deficit will be 4.6% of GDP. Cumulative adjustment is calculated as the difference in deficit in 2014 without measures and the projected deficit in 2016 with the measures.

The implementation of medium-term counter-cyclical fiscal policy, by implementing the principles of fiscal responsibility and proposed medium-term fiscal framework, will contribute to the reduction of debt to GDP ratio. In the long run, a further debt reduction is expected in order to stabilize debt to GDP ratio at the level of 45%. Regarding the scope of the debt, (part II of this chapter - Fiscal Policy for the period in 2014-2016), restitution is not included in general government debt, in order to provide the consistent comparison with the general fiscal rule regarding the debt.

2. Fiscal developments in 2013

Fiscal consolidation measures, which came into force in October 2012 have not given the expected results, and in 2013 tax revenues was lower than expected. This is primarily related to the excise tax on tobacco products, tax and non tax revenues. All this pointed to a possible shortfall in revenues during the 2013, which is exactly what has happened, as the income from the previous year forms the basis for projections of income in the current year. In addition to VAT and excise duties on tobacco products, a significant shortfall in CIT and non tax revenues was recorded. Given the unsustainability of such fiscal position it was necessary to adopt measures to make significant adjustments on the expenditure side, which is implemented in the revised budget for this year.

The following table shows the current projections of revenues, expenditures and fiscal deficit, based on the approved revised budget (excluding indirect budget users). The first column represents the initial plan of revenues, expenditures and deficit based on the Law on Budget for 2013 and the Fiscal Strategy for 2013 with projections for 2014 and 2015.

Table 4 2013 General Government Revenues and Expenditures – Budget, Revised Budget and Actual Estimate, in bln RSD

	2013 budget	**2013 revised budget**	**2013 estimate**
PUBLIC REVENUES	1.620.9	1,512.0	1,479.1
Current revenues	1.618.9	1,509.6	1,476.7
Tax revenues	1,432.0	1,342.2	1,311.1
PIT	188.6	163.1	158.4
CIT	79.1	54.2	59.0
VAT	434.3	404.3	390.2
Excises	233.3	217.3	210.5
Customs	35.6	34.6	31.9
Other tax revenues	45.8	39.8	42.8
Contributions	415.5	429.0	418.3
Non tax revenues	186.9	167.4	165.6
Grants	2.0	2.4	2.4
PUBLIC EXPENDITURES	1,753.2	1,710.8	1,688.9
Current expenditures	1,610.2	1,587.1	1,566.5
Expenditures for employees	406.3	403.6	401.3
Purchase of goods and services	261.6	250.1	243.2
Interest payment	95.7	97.3	97.3
Subsidies	119.1	110.8	102.7
Social assistance and transfers	692.4	690.4	687.0
of which pensions	*500.7*	*499.5*	*497.9*
Other current expenditures	35.2	34.9	35.0
Capital expenditures	131.7	110.8	109.3
Net lending	11.3	13.0	13.1
Fiscal outcome	-132.3	-198.9	-209.8
Fiscal outcome (% GDP)	-3.6	-5.3	-5.6

Source: MoF

According to current estimates, the consolidated deficit will be higher by about 2% of GDP, than the deficit that was planned for 2013 and the main reason is a significantly lower than expected revenue realization. Despite the relatively favourable macroeconomic developments, the reasons for the shortfall in budget revenues are numerous and vary in their nature and effects:

- A sharp drop in income and purchasing power in real terms at the end of 2012 and the beginning of 2013;
- Growth of informal market activity;
- Declining retail sales in real terms as a result of the first two factors;
- Decline in the profitability of the economy in 2012 and the consequent decline in dividends;
- Growth of illicit trade in tobacco products and directing consumers to the shredded tobacco consumption;
- The sources of economic growth, such as exports and agriculture are not generous as far as the revenue in the short term is concerned.

All these factors have led to the situation in which the changes in tax policy would not give the expected results in 2013 to a greater extent. The largest decline as compared to the initially anticipated revenues was recorded in the first quarter while it is expected that stabilization of certain tax forms and their approach to the expected values will occur in second half of the year. Still, it will not be enough to compensate for the shortfall recorded in the first half of the year and in accordance with that the design of the overall level of revenues in 2013 was made.

Amendment to the Budget provides for savings on expenditures of around 1% of GDP, net. Savings are largely made for capital expenditures and subsidies. In addition, changing the tax rate on salaries and contributions for pension and disability insurance reduced the need for transfers from the budget to the Pension Fund, enabling further savings of around 12 billion. These changes reduced the rate of income tax from 12% to 10% and increased the rate of contributions for pension and disability insurance from 22% to 24%.

3. 2014 – 2016 Fiscal Projections

The macroeconomic indicators medium term projection suggests sluggish economic activity growth. GDP growth will be generated by an increase in exports and investment, while a significant increase in employment and domestic demand could be achieved only in the long term. The high level of public debt and borrowing that is getting more and more expensive but also necessary for the financing of budget expenditures, suggests that the unsustainable debt rising trend has to stop urgently.

The following table shows the projected deficit under assumption that the measures of fiscal consolidation in the medium term are not applied. Among other things, the primary outcome is shown, which is obtained when the total score is reduced by the revenue and expenses from interest. The primary deficit is an indicator of fiscal policy, which in recent years has been extremely pro-cyclical and has led to the situation in which the interest payments have taken a substantial share in the expense structure. Augmented deficit (including additional costs) represents the fiscal balance plus the expenses that are recorded "below the line”. These are financial transactions of the state, such as paying activated guarantees, recapitalization of banks and companies, assuming the debt of other state entities and others. Although these costs have not been presented as part of the expenses “above the line ", and therefore as part of the deficit, their implementation was actually reflected in rising levels of public debt. By showing these expenditures stronger links between the actual fiscal results and net changes in the stock of public debt are established.

Table 5. 2013 – 2016 Fiscal Aggregates, as % of GDP, **No Consolidation Measures Implemented Scenario**

	estimate	projection		
	2013	2014	2015	2016
Public revenues	39.3	37.9	37.0	36.2
Public expenditures	45.3	44.9	44.5	43.1
Consolidated fiscal balance	-6.0	-6.9	-7.5	-6.8
Primary consolidated fiscal balance	-3.4	-3.9	-4.2	-3.2
Additional costs	-0.9	-1.7	-0.9	-0.9
Augmented fiscal balance (including additional costs)	-6.9	-8.6	-8.4	-7.7
General government debt	64.2	70.9	74.9	77.4
Real GDP growth rate	2.0%	1.5%	2.0%	2.5%

* for comparison with previous years it is necessary to use the balance excluding financial transactions

Medium-term fiscal framework accompanied by the proposed measures of fiscal consolidation provides for a significant reduction of the general government deficit to 2.3% of GDP (3.2% deficit with aditional costs) in 2016, with the stabilization of the public debt (Table 17). This implies a cumulative adjustment in the deficit from 5.4% of GDP to expenditures that appear "below the line". If we look at consolidation level without financial transactions "below the line", then the cumulative adjustment of the deficit will be 4.6% of GDP. Cumulative adjustment is calculated as the difference between the deficit in 2014 without measures and the projected deficit in 2016 with measures.

Table 6. 2013 – 2016 Fiscal Aggregates, as % of GDP, **Consolidation Measures Implemented Scenario**

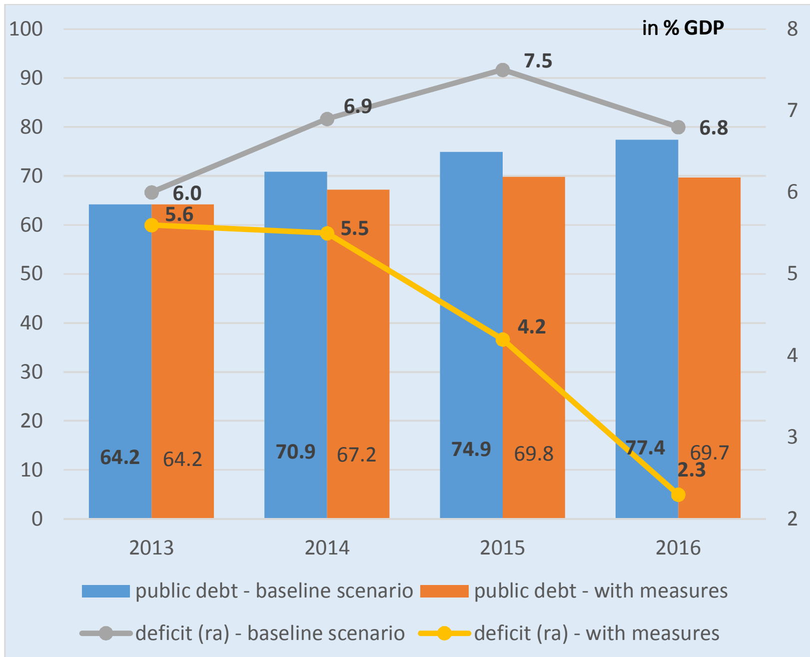
	estimate	projection		
	2013	2014	2015	2016
Public revenues	39.3	39.5	38.9	38.3
Public expenditures	44.9	45.0	43.1	40.6
Consolidated fiscal balance	-5.6	-5.5	-4.2	-2.3
Primary consolidated fiscal balance	-2.9	-2.5	-1.6	0.6
Additional costs	-0.9	-1.7	-0.9	-0.9
Augmented fiscal balance (including additional costs)	-6.5	-7.1	-5.2	-3.2
General government debt	64.2	67.2	69.8	69.7
Real GDP growth rate	2.0%	1.0%	1.8%	2.0%

Source: MoF

The increase of the consolidated deficit, which includes financial transactions outside the budget in 2014 compared to 2013, is the result of inclusion of the one-off expenditure commitments from previous years, expenditures for the completion of the restructuring of state-owned enterprises and expenses aimed at establishing the stability of the financial sector. These are expenditures that will be made in 2014, so it is expected that in 2015 and 2016 a significant fiscal consolidation will ensue. Just for the sake of comparison, without measures of fiscal consolidation, the deficit that includes additional costs outside the budget would amount to almost 9% of GDP in 2014.

2014 – 2016 fiscal aggregates forecasts are based on projections of macroeconomic indicators for this period, the planned tax policies which include further harmonization with EU legistlation and directives and the corresponding measures on the revenue and expenditure sides, leading to a reduction in the share of public spending in GDP and reduction of government deficit to 2.3% of GDP at the end of the period.

Graph 7. Public Debt and Deficit (without additional costs), as % of GDP



2014 – 2016 Fiscal Consolidation Measures

Movement of fiscal aggregates in the medium-term is a result of the application of fiscal consolidation measures whose effects are shown in the table below. The growth of expenditures based on labour in enterprises undergoing restructuring and the growth of capital expenditures funded from project loans will reduce the effects of these measures in 2014.

The effects of fiscal policy are shown as gross amounts, or as amounts which directly increase the revenue or decrease the expenses. The measures are presented so that each year sees a further lasting effect produced by a measure. The transferred effects over the next two years are taken into account as a permanent increase or decrease of the basis.

Some of these measures have resulted in a temporary increase in certain categories of expenditures. Completion of the restructuring and reduction of subsidies on these grounds require additional expenses in the form of necessary funds for the purchase of receivables based on employment in companies undergoing privatization and increased transfers to the National Employment Service. On the other hand, there is the effect of the public sector wages reduction on aggregate demand thus reducing the VAT collected. These additional effects are taken into consideration in the process of designing the fiscal framework until the year 2016.

Table 7 2014-2016 Fiscal Policy Measure Lasting Impacts on Deficit Reduction

	2014		2015		2016	
Measures	bln RSD	% GDP	bln RSD	% GDP	bln RSD	% GDP
VAT, increase of special rate from 8% to 10% and change of the list of products	21.4	0.53				
Reduction of public sector wages	11.9	0.30				
Reduction of subsidies to companies	12.1	0.30	4.0	0.09		
CIT – abolishing exemptions			8.2	0.19	4.4	0.10
Reduced wage and pension indexation			14.6	0.34	12.6	0.27
Refinancing of the expensive portion of public debt	0.9	0.02	25.1	0.58	5.4	0.12
Combating the shadow economy	10.0	0.25	10.7	0.25	11.4	0.25
Tobacco excises – combating the shadow economy	5.9	0.15				
Reduction of expenditures for goods and services	4.1	0.10				
Reduction of expenditures for employees			25.7	0.6	20.6	0.45
Pension system reform					4.4	0.1
Increased social spending			-7.5	-0.18		
Total	66.3	1.65	80.8	1.88	58.8	1.28

Source: MoF

1) VAT - increase in special rate from 8% to 10% - Special VAT rate currently stands at 8% and is applied to a significant number of products, particularly basic foodstuffs. The share of these products in total turnover is about 40%. The estimated effect of increasing the rate to 10% is about RSD 21.4 billion or 0.53% of GDP, and this amount includes the effect of the transfer of certain product categories from specific to the general rate, such as hotel services and computer equipment.

Projected effect of increase of the specific rate of gross payment of VAT in 2014 amounted to RSD 28.4 billion. An increase in the VAT returns (the effect is about RSD 7 billion) is estimated bearing in mind that many products that are taxed at a special rate (utilities, water, gas, raw materials for the food industry, etc.) are inputs in the food and other export-oriented industries. The initial effect on revenue projected budget in the amount is of RSD 21.4 billion.

On the other hand, increased gross tax reduces the available funds in the same amount of population living in conditions of limited income. The reduction of available funds will be reflected in lower consumption especially of products taxed at a higher rate (due to the inelasticity of consumption of basic food and utilities). These effects are taken into account in the projection of the total VAT revenue.

2) Reduction of public sector wages - a decrease in percentage of net salaries of public sector employees above certain thresholds (60,000 and 100,000 net) is anticipated. Thus, the net income bigger than 60,000 and lower than 100,000 RSD per month will be reduced by 20% (reduction will be applied on the part of benefit above 60,000). For net income of more than 100,000 per month, the amount of 60,000 to 100,000 will be reduced by 20%, while the amount exceeding 100,000 will be reduced by 25%. This measure will be applied to the entire public sector, including all budget beneficiaries, public enterprises and local administration. The basic idea of this measure is to transfer the burden to the public sector employees who have higher income. The main idea of these measures is expressed in the existence of two thresholds, as well as a part up to RSD 60,000 which is exempt from reduction, thus introducing a significant progression in the distribution of the tax burden. It is estimated that this measure will comprise about 180,000 employees in the public sector.

Table 8 Public sector wages reduction example, in RSD

Net public sector wages before the reduction	Reduction	Net public sector wages after the reduction
60,000	0	60,000
70,000	2,000	68,000
130,000	15,500	114,500
Reduction (130,000) = 20%*(100,000-60,000) + 25%*(130,000-100,000)		

This measure does not provide for the reduction of the total wage bill, i.e. amounts budgeted as expenditures for salaries will remain unchanged, but the funds raised in this way appear as a form of non tax revenue. The reason for this was the need to avoid a further decline in revenues from income taxes and contributions, due to lower gross earnings, which would jeopardize the fiscal position, primarily of social funds and local governments. Also, PE and other entities are not part of the general government so that the savings as such would not be effected on the expenditure side. Lack of disposable income on this basis will be reflected in lower consumption and the revenue coming from the consumption tax. These assumptions have been directly taken into account in preparation of the baseline projection of gross VAT collection in the future.

3) Reduction of subsidies - A significant space for savings in expenditures in the period from 2014 to 2016 exists in the area of subsidies. In this regard, it has been planned for the year 2014 that important savings should be accomplished, primarily through the reduction of subsidies in the areas covered by the ministries of economy and agriculture amounting to 10% (about 0.2% of GDP) and subsidies given from the local self-government budgets that should be reduced by 0.1% of GDP (which will be achieved by reducing subsidies to local utilities for a fixed percentage). The efficiency of local self-governments in the restructuring of local public utilities and the consequent reduction of subsidies to these companies represent an important parameter for determining the transfer from the state budget to the budgets of local governments. Large cities (notably Belgrade and Novi Sad) are important providers of subsidies to local public enterprises. Therefore, it is anticipated that the savings that these cities will achieve by decreasing subsidies to local public utility companies, will be focused on the financing of some social assistance programs, which will be transferred to the cities and will be in their jurisdiction and responsibility..

Within the total expenditures for the subsidies given out in Serbia, a relatively large part are indirect subsidies to public enterprises (PE "Srbijagas" Galenika ad, Smederevo Steel Works Ltd. and others), for the repayment of their debts guaranteed by the Republic. In the baseline scenario in 2014 it is planned to adopt a relatively restrictive approach that would involve termination of any direct or indirect support to these companies after the year 2014.

In addition, it is necessary to review the rationale of all existing subsidy programmes, so that in the coming year only those who have some positive effect on investment and economic growth would receive funding.

4) CIT – abolishing exemptions - elimination of relief - the amendments to the Law on Corporate Income Tax, should come into force in 2015 reducing a set of tax incentives (through the elimination of the investment tax credit), which will increase the revenue from this tax. Data for the CEE countries show that with the moderately low tax rate, tax incentives do not have a significant impact on the investments inflow, but they do have an impact on the expenditure side.

5) Reduced wage and pension indexation – Limitations in the growth of salaries and pensions represent indispensable measures taking into account that these two categories together account for about 55% of all general government expenditures. Limitation of growth involves two annual indexations in salaries and pensions by 0.5% in the 2015 and 2016 (April and October), in contrast to the current legal provision that provides for indexation in line with the increase in consumer prices. The increase in salaries and pensions is also limited in 2014, which is regulated by the Budget System Law.

6) Refinancing of the expensive portion of public debt - This measure relates to lower liabilities related to the interest, due to the expected revenue from the sale of part of state property and favourable borrowing, which will allow early repayment of debt with the highest interest rates, and reduce the need for new borrowing. The savings were calculated assuming that the funds received under this heading would be used to pay the most expensive loans. The reason for the absence of major savings in interest expense in 2014 is that it is paid semi-annually (at maturity of coupon bonds) or once a year, so that these measures, which will be implemented in the first half in 2014, will show their effects only in the second half in 2014 and 2015.

7) Combating the shadow economy - the reduction of tax evasion and the ‘underground’ economy and increase of tax revenues from these, primarily depends on the efficient operations of state authorities in the combat against the informal economy. It is anticipated that the effects that are expected will bring higher income, primarily related to VAT, income tax and contributions. Better collection of excise duties on tobacco by reducing smuggling and enforcement of measures against traffic of shredded tobacco also depends on the improvements in the work of institutions. In the table above, the effects of combating the informal economy in the form of better tax collection of the VAT, taxes and labour-related contributions are given for each year separately as an additional effect. In the case of increasing the collection of excise duties on tobacco, it is the effect in the first year that is transferred to the next period.

Overall measures in the area of reducing the informal economy will include, among other things, the reallocation of tax administration workers with administrative duties to other positions dealing with detecting obvious forms of tax evasion, reduction and simplification of tax procedures, increasing the number of tax workers involved in the control of the taxpayers, increasing their skills and improvement of the methodology for the selection of control subjects. Comprehensive regularization of penal policy in the area of tax offenses, misdemeanours and criminal offenses will take place, so that the criteria for determining the sentence will become unambiguous, and the fines higher than now. The practice of consistent application of the punishment for tax evasion and a review of sentencing policy will be improved and coordination of activities of Coordination of Tax Administration and other government agencies will be carried out, especially in terms of information exchange. The measures will apply to the promotion activities regarding better collection of reported tax obligations, committing the state not to carry out a write-off of receivables from interest on unpaid public revenues and others. In addition, the announced amendments to the Labour Law towards increasing the flexibility of employment, with increased activity of inspection services, will also contribute to the reduction of the informal economy in the area of labour and employment.

8) Reduction of expenditures for goods and services - savings in procurement related to the reduction of discretionary spending in the budget of 15% compared to those provided for the revision of 2013[6]. Fixed costs that depend on the cost of services paid by public bodies are increased in line with the assumptions about the growth rate.

9) Reduction of expenditures for employees – A reform of the system of salaries in the public sector will be undertaken in 2014 through the introduction of standardized salary grades, the correction coefficients and methods of advancement and rewards to employees, correction of the method of determining the fee for membership in the governing bodies, committees and the like. These changes are accompanied by corresponding changes in funding of local communities and funds of mandatory social insurance, so that the cost of savings realized on this basis offset an increase in other expenses at the state level, but also lead to a reduction of the consolidated fiscal deficit. The reform of the salary system should be implemented by the end of the first half of 2014. In the contrary case, activation of the new fiscal rules will be considered through amendments to the Law on the Budget System, by the application of which the wage bill will be down to a target level. Program of reform of the wage and employment in order to reduce payroll expenditures and increase the efficiency of work, as the next step, will include the adjustment of the number and structure of employees in the public sector to fit the needs, in accordance with the priorities set

[6] This measure resulted in lower total consolidated deficit, while savings on other items were achieved in the budget process.

in the national development plan to be approved by mid-2014. So, in 2014 an analysis of the structure of employment in the public sector will be done, based on data from the Registry of staff and other resources, from which estimates of the necessary changes and restructuring in the public sector will be prepared. On this basis, in the second half in 2014, the programme of restructuring of the public sector and the related legislative proposals will be made, which, after appropriate public hearing, should be adopted by the end of the year so as to make the start in 2015 possible as the first step in the implementation of the programme. Rough estimates show that the reform of the salary system and optimization of the number and structure of employees in the public sector will lead to a reduction in payroll expenditures of 0.6% of GDP at the latest by 2015 and 0.45% of GDP at the latest by the beginning of 2016.

10) The pension system reform - the plan of structural reforms envisages that by the end of 2013, or partly in 2014, the reform of the pension system will be legally codified. Its main elements are increasing the retirement age for women, introducing actuarially fair penalty for early retirement and tightening the criteria for allowing pensions based on especially hard working conditions. Such a reform would provide savings in pension expenditures in 2016, amounting to 0.1% of GDP per year. These effects will increase as the years pass.

The effects of the measures are presented separately for each year, even though the cumulative effect of increases is bigger since the implementation of the measures adopted in one year brings greater savings effects in the next year as well. It is important to note that the table does not include the effects of the completion of the restructuring of socially-owned enterprises -SOEs, as they are in line with the directives of the Government and the already-adopted restructuring plan and as such, have already been included in the scenario for the case assuming no consolidation measures. This process will have, in an initial period, a negative impact on fiscal balance, while the savings that according to the World Bank estimates reach 750 million euros a year, will be visible at the end of the period (part of this effect is seen in the reduction of financial transactions outside the budget). Positive indirect effects are reflected in the creation of an enabling business environment in which tax and commercial debts to creditors will not accumulate.

Depending on the results of the analysis of the register of public sector employees and the effectiveness of the fight against the informal economy in the coming period, some additional measures, not included in the existing fiscal framework, will be considered to ensure greater fiscal consolidation.

1) Hiring freeze for positions that become vacant by the natural outflow - Consideration shall be given to the possibility of temporarily prohibiting hiring new people instead of those who leave the public sector due to natural outflow (retirement, etc.) except in cases with exceptional circumstances which have to be approved by the Ministry of Finance. At the same time, in case of a need to replace a person who retired, it will be possible for the institution in question to hire a new employee if number of employees reduced the number due to departure of a person on another position, so that the number of employees at end of a period (quarter / year) is equal to the number of employees at the beginning of the year, less the number of people who hired in the given period. In this way, the institutions will be encouraged to optimize the structure of employees, downsizing where they have excess and hiring additional people in the places where it is needed. The measure would apply to the entire public sector, including direct and indirect budget users, agencies, public corporations, companies with majority state ownership at all levels of government (Republic, Autonomous Province of Vojvodina, local self-government).

Assuming that through natural outflow, the public sector loses annually around 3% of its employees and that due to special needs a permission is granted to replace 10% of employees on the existing working places, it is estimated that in this way the savings in expenditures for staff will be of around 0.20% of GDP in the first, and an additional 0.30% of GDP in the second year of implementation. Further improvement of the mechanisms for the redistribution of resources within the public sector will ensure that these savings are not offset by an increase in other, non-productive expenditure.

2) Introduction of financial activities tax - the burden of fiscal consolidation in Serbia will be borne primarily by the employed in the public sector (through wage cuts, downsizing, reducing discretionary spending), and the remaining population (the VAT increase), as well as by the companies in the real sector (by reducing demand and the elimination of the investment tax credit, etc.). Accordingly, in order to achieve a more equitable distribution of the burden of fiscal consolidation, the introduction of a value added activities in the field of financial intermediation (Financial Activities Tax) will be considered. As a model, based on which the taxes-related functioning would be designed, a solution recommended by the European Union member states would be used. This would imply that the tax base is defined as the value added of the financial sector, determined as the sum of earnings before taxation and expenses for the employees. Assuming that this tax is introduced at a rate of 7%, the estimated effects of these measures would amount to about 0.1% of GDP and could be achieved already during 2014.

3) Other measures

a) More efficient management of discretionary expenditures. – It is estimated that by improving regulations and stronger control, significant further increases can be achieved regarding the efficiency of management and other discretionary expenditures. In that sense, we will consider possibilities for the improvement of per diem expenses for business trips and travel expenses, expenses for the use of company cars, expenses from rental of real estate in the country and abroad. It will be possible to review and revise the simultaneous realization of the right to a salary and a pension from the public sector. Expected savings in expenditures under this heading are estimated at around 0.1% of GDP, most of which will be realized already during 2014 and 2015.

b) Further reduction of tax expenditures and expanding tax coverage - In order that the burden of fiscal consolidation is fairly distributed and expenses in the tax system by use of space created by the tax breaks and similar are reduced, a possibility of further reducing the group tax relief will be created in 2014. Apart from that, further reform of laws and regulations that should lead to the extension of coverage and a more realistic assessment will be carried out in 2014 and 2015, and that could provide additional tax revenues of around 0.1% of GDP. By adopting the Republic of Serbia

Budget law for 2014 and by amending other regulations, by which was carried out normative implementation of larger part of announced measures, preconditions for starting of negotiations about precautionary arrangement with IMF in 2014 have been created.

2014 – 2016 Fiscal Projections

Total public sector revenues, without the indirect users, showed a declining trend when it comes to the share of GDP, given that nominal GDP growth is faster than revenues. The reason for this trend is the fact that revenues largely depend on the demand which, in the conditions of slow growth and limited income, grow more slowly than GDP. The GDP growth in the future will be primarily determined by the growth of exports and investments which, in the short term, are not generous by their nature. In the case of higher growth rates over a long term, one can expect higher growth in employment and salaries, which would lead to a significant increase in demand. In addition, the revenue trend will depend also on the fight against the grey economy and tax evasion that have assumed alarming proportions.

Table 9 2013 – 2016 Public Revenues and Grants, as % of GDP

	estimate	**projection**		
	2013	2014	2015	2016
PUBLIC REVENUES	39.3	39.5	38.9	38.3
Current revenues	39.3	39.3	38.7	38.1
Tax revenues	34.9	35.4	34.9	34.5
PIT	4.2	3.9	3.8	3.8
CIT	1.6	1.6	1.8	1.9
VAT	10.4	10.7	10.4	10.1
Excises	5.6	5.7	5.6	5.5
Customs	0.8	0.7	0.7	0.7
Other tax revenues	1.1	1.4	1.3	1.3
Contributions	11.1	11.3	11.2	11.2
Non tax revenues	4.4	3.9	3.8	3.6
Grants	0.1	0.2	0.2	0.2

Source: MoF

Personal income tax. Income tax is projected at around 3.8% of GDP in the future. It is mostly comprised from wage tax. Revenue from taxes on salaries depends on changes in the wage bill and employment trends. Since it is expected that the wage growth will be in line with productivity growth but it is also expected that a moderate deterioration will be recorded in employment, it is reasonable to expect that revenue from income tax would have a relatively stable share of GDP over the period.

Limiting the growth of salaries in the public sector also contributes to slower growth of revenues from this tax. The estimated baseline growth of 4.4% includes an estimate of higher level of collected revenue as a result of the effects of measures to reduce the shadow economy.

The projected annual decrease in income taxes in 2014 was a result of changes in the income tax rate from 12% to 10% and increase of the “tax-free threshold” to RSD 11,000 in June 2013.

Social contributions. Contributions for obligatory social insurance (OSO) represent the largest single form of public revenue. Participation of these contributions in GDP is more than 11.0%. The changes in the share of this public expenditure in GDP has a similar path as the wage tax since their projections were based on similar assumptions regarding salaries and employment in the medium term. Contributions are the tax category that is most prominent as violators of tax discipline and that is where the largest taxpayers' debt was registered. Start of compulsory social insurance - CSD should enable better control and collection of these revenues. The projected revenues from income taxes and contributions include the effects of the fight against the informal economy. In June 2013, the rate of pension contributions increased, while the contribution rates for the other two forms of social insurance remained unchanged. This leads to a significant year-to-year jump in collection of pension contributions with less negative impact on other forms of contributions, due to a slight reduction in the total effective tax burden on salaries.

Corporate income tax. Changes to the Law on Corporate Income Tax in 2013 have increased the rate of corporate profit tax from 10% to 15%. Low profitability of the economy in 2012 led to a decrease in participation of this tax in the GDP in 2013 as compared to the previous year, when this indicator was 1.6%. Projection for 2014 was done on the basis of assumptions of the profitability of the economy remaining relatively unchanged, so that the increase from 2013, results only from the fact that the new tax rate (15%) will be applied to each amount of monthly payment (in March of 2013, the payments on the basis of the final balance was at the rate of 10%) and on the assumption that there will be no significant returns on the basis of overpayments. This year will likely be more successful due to the profitable operation of the economy, so that there is a positive risk in the collection of this tax. In the medium term, a moderate growth in economic activity is expected which will positively affect the movement of this tax. Also, the adoption of amendments to the Corporate Income Tax Law repeal certain tax benefits and increase revenue on this basis.

Value-added tax. VAT is projected at 10.4% of GDP in the 2013, and by the end of 2016, the projected decline in the share of GDP is below 10.1%. The projected increase in 2014 is a result of the increase in specific rates from 8% to 10%. The main determinant of movement of VAT is domestic demand driven by disposable income of the population. In the future it is expected a slight nominal increase in demand caused by the movement of the estimated earnings and employment, but slower than nominal GDP growth which explains the decline in the share of this tax to GDP ratio. The slower growth of the tax form, or the decline of its share in GDP is explained by the changes in consumption patterns, rapid growth in exports and an increase in investment activity as the ultimate goal of economic policy. The projection of the VAT revenue includes the effects of the fight against the informal economy and tax evasion.

Disposable income as a determinant of consumption, depends on changes in public sector, salaries, pensions, social assistance and movement of the wage bill in the private sector. Taking into account that all categories, except for salaries in the private sector are largely limited, the disposable income growth also is expected to slow down in the future. An additional effect appears due to the introduction of reduced earnings and the completion of the restructuring of the former socially-owned enterprises - SOEs. If there is a slowdown of the process, the real decline of disposable income will be lower, and gross VAT collection somewhat higher. The real decline in consumption and the consequent turnover in the next year is about 1%. Basic assumptions for projections of VAT in 2014 are:

- Nominal growth of gross collection is estimated at 4.5% (real disposable income fall by 1.1%). Introduction of reduced salaries and increase of the special tax rates negatively affect the market and lead to a growth rate of gross collection of about 3.5%;
- The increase in VAT refunds of about 14% caused by projected trends of imports and exports, including the effect of causing an increase in the special VAT rates;
- The estimated net effect of increasing the specific rate of VAT of 21.4 billion dinar;
- The estimated effect due to improved collection due to combating the informal economy in the amount of 4.9 billion dinars.

As a basis for assessing the gross collection in 2014 the expected gross collection in 2013 was taken as a basis, but slightly modified. Specifically, in January 2013 a part of collection of the income earned on the payment of quarterly payers was missing due to the moment of start of application of the amended regulations. In this way, the first month of 2013 for all practical purposes was lower by about 2 billion dinars, but it will not happen again in 2014 so that the same amount was added to the computation basis used in 2013. Also at the end of 2012, a part of the obligations under the excise tax on cigarettes (postponed to October 2012), was missing and that has caused the lack of income tax at the beginning of 2013. It is estimated that the effect of these temporary changes to the schedule of payment of excise duties on cigarettes was about 2 billion dinars and for that same amount but only for projections of VAT, the gross collection was adjusted in 2013.

The greatest impact on the movement of VAT is made by the of level of disposable income of the population, and any further real decline (slower nominal growth) of 1p.p. entails effect of about 5 billion dinars less of VAT collected.

Excise duty. Projected revenues from excise taxes was made on the basis of the excise policy, the projected consumption of excisable products (petroleum products, tobacco products, alcohol and coffee) and regular adjustment of the nominal amount of excise to inflation in the previous year. As for the excise policy of excise goods in the medium term, it is expected that a gradual harmonization with EU directives will continue. This requires adoption of medium-term plan of gradually increasing the excise burden. In case of tobacco, it will be directed by specific tax with the aim of achieving, by 2020, the EU minimum of 1.8 euros per pack of the cheapest cigarettes and other tobacco products by increasing the minimum tax to gradually equalize the excise burden with cigarettes and to avoid changes in the structure of demand that could jeopardize the tax revenue and would be contrary to the objectives of public health policy.

The plan is to raise a special excise tax per pack for 2 to 2.5 dinars every six months in 2016 while gradually raising the minimum excise duty on cut tobacco in the same period. The projected revenue from excise duty on tobacco products includes the effects of the fight against the informal economy, which largely involves suppression of illicit trade in cut tobacco, as well as the natural downward trend in the consumption of tobacco products, which has existed for several years now. The estimated effect on that basis is 6.2 billion. Although the decline in revenue due to spending on cut tobacco is higher, it is estimated that a portion of consumers have permanently switched to pipe tobacco bought from legal sources. The risks to the achievement of revenue projections from taxes on cigarettes exist in case that the expected effects of measures in the informal economy re not materialized and that there is a significant drop in consumption (quantity and value) due to price increases.

In case of excise tax on petroleum products, a system of differentiated excise duty was introduced on gas oil (diesel) and liquefied petroleum gas, depending on the end use. So, if the fuel is used as a motor fuel for transport and agricultural machinery or heating purposes, rebates were introduced, equal to the difference up to the amount provided by law. In case of excise tax on gasoline, differentiation is not planned, and the goal is to be in the medium term equalizing excise tax on diesel and petrol for cars. Projected growth of consumption of diesel (gas oil) was observed in the previous period as well as a slight increase in consumption of LPG. Motor gasoline consumption has been in decline for years, and that trend is taken into account in the projection. In particular, the projected revenues from excise duty on diesel used in agriculture and at the moment when they are known for 2013, are projected in such a way that the revenue (to the fullest extent and expense) for this purpose will be about 6.7 billion. The excise policy will be reconsidered as well as the regulation regarding imports and trade of base oils.

Customs. Projected revenues from customs duties are directly related to the scope and structure of imports. Considering that since 2009 the Interim Trade Agreement with the EU is in force, and that in the meantime, free trade agreements with Turkey (2010) and EFTA (2010 - for Switzerland and Liechtenstein, 2011 - for Iceland and Norway) have entered into force on, decreasing the share of these revenues in the GDP, and that it ended in 2014 when the harmonization of tariff rates according to the Interim Trade Agreement with the EU and European Free Trade Agreement with EFTA countries, should be completed, as well as the agreement with Turkey. After that it is expected stabilization of revenue in relation to GDP.

Other tax revenues. A significant part of this cathegory is the property tax, and taxes on the use, possession and carrying goods are projected in accordance with the movement of inflation, because inflation has a significant impact of these tax forms. The level of this income is relatively stable and the reaction to the fall in economic activity are increasingly prominent. This is the reason that in times of major crisis and slower growth in other tax revenues, the share of this category to some extent increases. In the medium term, which is characterized by economic growth, the share of other tax revenues stabilize. Jump into in 2014 was a result of changes in the legislation concerning property taxes in part related to the property tax of legal entities, or involving land use fees in property taxes.

Non tax revenues. Non tax revenues reduce the share of GDP over the medium term. Non tax revenues mainly consist of various taxes, fees and sales of goods and services whose movement is largely dependent on demand and economic activity so that the nominal growth in the future is expected, but still slower than the growth of GDP. In the period from 2014 to 2016 the income from salary cuts is included in non tax revenues, and excluded is the income from land use fees collected at the local level, which will become part of the property tax.

Grants. Republic of Serbia as a candidate country for EU membership in the next period will increase IPA funds that can be used, so a slight increase in the share of these funds in the total income and GDP is expected.

Table 10 2013 – 2016 Public Expenditures, as % of GDP

	estimate	**projection**		
	2013	2014	2015	2016
PUBLIC EXPENDITURES	44.9	45.0	43.1	40.6
Current expenditures	41.6	41.1	39.0	37.4
Expenditures for employees	10.7	10.3	9.3	8.5
Purchase of goods and services	6.4	6.6	6.5	6.5
Interest payment	2.6	3.0	2.6	2.9
Subsidies	2.7	2.6	2.5	2.2
Social assistance and transfers	18.3	17.6	17.2	16.5
of which pensions	*13.2*	*12.8*	*12.3*	*11.8*
Other current expenditures	0.9	1.0	0.9	0.9
Capital expenditures	2.9	3.3	3.6	3.1
Net lending	0.3	0.6	0.5	0.2

Source: MoF

Fiscal adjustment on government expenditures in the period was 4.2 percentage points. Most of the adjustments were related to current consumption, thus avoiding large drop in the share of public investment in the medium term. Specific fiscal rules ensure that the fiscal deficit to GDP ratio is predominantly achieved in this way.

Major austerity measures are: limiting the growth of salaries and pensions, reform of salaries in the public sector, completion of the restructuring of SOEs and dealing with inefficient public enterprises. On the expenditure side, the priority in the next period goes to the infrastructure investments and agricultural development so that in case of creating additional fiscal space, the available resources will be directed to these two areas.

Expenditures for employees. Salaries in the public sector, as envisaged in the fiscal rules, are adjusted according to the movement of inflation and a part of the GDP growth from the previous year which is higher than 4%. Exceptionally, in 2014, the first indexation (in April) will be at the level of 0.5% (as in October 2013) and the second (October) according to the fiscal rule. After that, starting with the April indexation in 2015, the salary will be indexed with 0.5%. Taking into account the projected inflation during that period, a significant decrease in the share of payroll expenditures in GDP is expected. Apart from the limitations in the growth of the earnings in 2015 and 2016, a comprehensive reform of the wage system and the changes and rationalization in the public sector are also provided for which should result in savings of about 1% in the period.

Expenditures for goods and services. For this category of expenditures, a relatively stable share of GDP is provided. The exception is the Republican budget which envisages to reduce discretionary spending, so that in 2014 these expenses should be decreased by RSD 4 billion dinars. This category of expenditures was significantly reduced in 2013 (from 7.0% of GDP in 2012) which seemed to be due to several factors: elimination of own revenues allowing for more efficiency in managing budgetary funds, as well as their control, bringing order to the procurement process and the slowdown in inflation.

Repayment of interest. The costs of repayment of interests are at historically highest level accounting for nearly 3% of GDP. Extremely high levels of public debt could bring the participation of interests in the GDP to 4.0% in the coming period. To avoid this, it is planned that the important funds should be obtained by privatization and provision of soft loans that should be used for the early refinancing the most expensive portion of public debt, which would lead to substantial savings in the interest liabilities. In addition, stabilization of public debt in the future should lead to a gradual decline in interest rates, both in nominal and in relative terms.

Social benefits and transfers to households. The largest category of transfers to households are pensions. In accordance with the Law on the Budget System and special fiscal rule governing pension adjustments, the plan is to adjust the pensions in the same way as salaries. As with the salaries in the public sector in October 2013 and April 2014, the indexation will be fixed at 0.5%, while in October 2014 it will be in accordance with the fiscal rule. After that, starting from 2015, the pension increase would be coordinated by 0.5% in April and October. In 2012, the share of pensions in GDP was 14.3%, and the goal, which is defined by the fiscal rules, is the decline in the share of pensions in GDP to 10%. During the next medium term it is expected to reduce this share to 11.8%, which would be a result, in addition to fiscal rules, of the slowdown in the number of pensioners as a result of parametric reforms in the pension system that have already begun to effect. Other social benefits and transfers to households in the period 2014 to 2016, will be adjusted using the prescribed indexation, current and planned policy changes in this area and the projected number of users. In addition, higher required funds for certain types of social support are expected given to sharp fiscal consolidation measures in the future. The share of expenditure on social security benefits, falling from 19.2% of GDP as was the 2012 to 16.5% in the 2016. Significant change in social policy is the payment of maternity leave at 100% of salary, starting in 2014.

Subsidies and net lending. Fiscal adjustment in the analysed period will largely be carried out by reducing funds for subsidies and net lending. Assumptions to reduce these expenditures are the completion of the restructuring of social and public companies, as well as redefining the industry support measures to focus the limited budget resources on more efficient programs to support the economy, which can achieve the best results from the standpoint of enhancing economic growth and reducing unemployment. In 2014 and 2015, significant funds in the form of net lending for the purchase of receivables from employment in companies in the privatization process were provided.

Capital expenditures. Priority area on the expenditure side is a capital investment. By reductions in current expenditure of the state sector, a space is created for maintaining the level of public investment at around 3% of GDP in the medium term.

Given the limited resources, special emphasis in planning investments in the medium term will be put on the investments of national importance (Corridors X and XI, the South Stream pipeline). In order for a significant increase in the share of capital expenditures to happen, in terms of fiscal adjustment, a more robust and dynamic economic growth is required.

Public Debt Reduction Programme

In accordance with the principle of fiscal responsibility, if general government debt exceeds 45% of GDP, the government is obliged to propose measures that will put debt closer to the proposed target, i.e. go back to sustainable debt level. The economic crisis that started at the end of 2008 had as a consequence a decrease or slowing down of the growth of budget revenues. In terms of lack or total absence of structural measures there was an increase in the annual fiscal deficit. In the period from 2008 to 2012, the general government deficit increased from 2.6% to 6.4% of GDP, and its growth was recorded in each of these years. At the same time the public debt took the explosive growth path, with the debt to GDP ratio doubled, from 30% of GDP at the end of 2008 to 61% of GDP at the end of 2012 with increasing levels of debt during that year only by about 13 percentage points.

Fiscal consolidation measures adopted at the end of 2012 halted this trend. The full effects of these measures were not achieved in 2013, but with a projected fiscal deficit of 5.6% of GDP, the growth of debt is slowing, estimated at 64.2% of GDP. The current level of public debt, and in particular the pace of its developments in the past are not fiscally sustainable.

The envisaged measures to stabilize the state budget, which envisages cumulative adjustment of 4.6% of GDP (5.7% of GDP, with augmented deficit) for the period 2014-2016, are leading to lowering of the general government deficit to 2.3% (3.2% of augmented deficit) of the GDP in 2016. In the same period stabilization of the debt at 69.7% of GDP should be accomplished. The fiscal deficit is not the only factor that affects the level of the public debt, and therefore it is necessary to implement additional measures, as shown below, through improved public debt management:

- Limitation on issuance of new guarantees, in particular guarantees to public enterprises for the current liquidity and guarantees to local self-government;
- Restriction on signing new project loans in cases when the previously approved loans have not been not used efficiently;
- Refinancing of an expensive portion of debt by using funds from soft loans and privatization proceeds.

The programme of measures to reduce the fiscal deficit and fiscal framework for the period 2014-2016, which is scheduled to decrease the consolidated fiscal deficit to 2.3% in 2016, represents the basic scenario and an integral part of public debt reduction programme.

According to the fiscal rules, it is necessary to predict the dynamics of lowering the level of overall debt level to 45% of GDP. The scenario presumes the achievement of propose debt level by 2025. Such a long period of adjustment is based on the assumption that the annual adjustment of the deficit larger than 1 pp of GDP is not feasible in the long term and in the conditions of slow or moderate growth without provoking major consequences for the population and the economy.

The assumptions in the baseline scenario are:

- Fiscal adjustment in the post-2016 period will be continued at a slightly lower level than the one anticipated during the period from 2014 - 2016;
- The gradual decline in the share of public revenues by 0.5% a year on average;
- Achieving fiscal balance in 2022 and a slight fiscal surplus in the period thereafter;
- A net gain of guarantees issued on average around zero after 2017 (in accordance with the requirements for the period from 2014 to 2016);
- Real GDP growth of 3.5% in 2020 with a gradual slowing down to 3%, in the long run, which implies an average growth to an extent greater than the potential;
- The average change in the nominal exchange rate of 2% per year in the observed period;
- No significant adverse effects on interest rates;
- No significant privatization proceeds in the period 2017-2025.

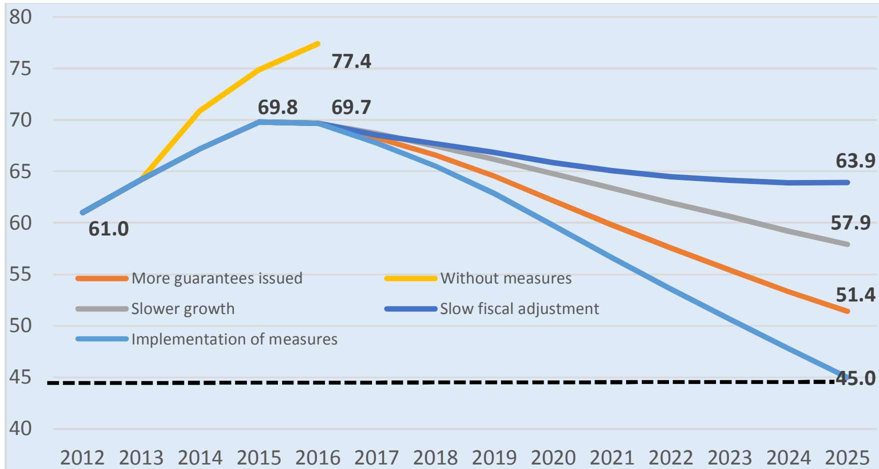
Table 11 2012 – 2025 Total Public Debt Simulation – Baseline Scenario

Measures implementation scenario	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**	**2024**	**2025**
Revenues	41.5	39.3	39.5	38.9	38.3	37.9	37.5	37.1	36.6	36.1	35.6	35.2	34.7	34.3
Expenditures	47.9	44.9	45.0	43.1	40.6	39.8	39.0	38.2	37.3	36.4	35.7	35.1	34.6	34.2
- adjustment		-3.0	-0.1	-1.8	-1.5	-0.8	-0.8	-0.8	-0.8	-0.8	-0.7	-0.6	-0.5	-0.4
Fiscal balance*	-6.4	-5.6	-5.5	-4.2	-2.3	-1.9	-1.5	-1.1	-0.7	-0.3	-0.1	0.0	0.1	0.1
Fiscal balance**		-6.5	-7.1	-5.2	-3.2	-2.8	-2.4	-2.0	-1.6	-1.2	-1.0	-0.9	-0.8	-0.8
Public debt to GDP ratio	61.0	64.2	67.2	69.8	69.7	67.8	65.5	62.8	59.8	56.6	53.6	50.6	47.8	45.0
Public debt to GDP ratio (without measures)	61.0	64.2	70.9	74.9	77.4									
Real GDP growth rate	-1.7	2.0	1.0	1.8	2.0	3.0	3.0	3.3	3.5	3.5	3.4	3.3	3.2	3.1

* Fiscal balance without additional costs
** Augmented fiscal balance (including additional costs)

In this scenario, the burden of fiscal adjustment will mostly take effect at the beginning of the period with a gradual decline. Total cumulative adjustment in 2014, on the expenditure side is about 12 pp or slightly below 0.8 pp per year on average. The experience so far indicates that this level of consolidation is at the upper limit of possibilities, but is still plausible. Significant contribution to reducing the expenditures at a later date, due to a gradual decrease in the level of debt, would be accomplished by the reduced expenditures for interest, which is a positive change in the structure of expenditures. Movements in interest-related expenditures in the period 2013-2016, significantly reduce the effects of cost savings achieved on other positions, and their reduction, as the most unproductive expenditures, should be a priority.

Graph 8. Comparison of Different Scenarios and Their Impact on Public Debt Level, as % of GDP



The graph shows the simulation of alternative public debt scenarios, according to changes in the assumptions in the baseline scenario. For a better comparison one can make a variation of one variable that affects the level of debt. In reality, there are many combinations of possible movements of different factors that affect the public debt.

Scenario “slower growth“ means the average real GDP growth of about 2.1% in the observed period with the same level of fiscal deficit. At the end of the period, public debt would stand at the level of 57.7%. The risk implied by this scenario of prolonged slow growth is that despite the same level of fiscal adjustment on the deficit, public debt is not falling fast enough. On the other hand, slow growth does produce higher levels of fiscal deficit by itself, so that there is even bigger need for the reduction of expenditures in order to maintain the path that is already unfavourable as it is. Due to that, entering in the circle of slow growth, high deficit, the need for austerity measures and further slowdown is therefore difficult to avoid.

Scenario “slow fiscal adjustment" implies a slower adjustment of expenditures that are at the level of 0.4 pp yearly on average, while in the observed period the fiscal deficit does not fall below 3% of GDP. In this case there is no significant reduction in the level of public debt despite a fiscal adjustment. In the case of a combination of this and the previous scenario, the level of debt would take an explosive path.

Scenario “more guarantees issued“ means a net increase of guarantees issued at the level of 0.5% to 0.9% per year while retaining the other assumptions. This assumption implies the retention of the level of net growth of guarantees issued, which is present in the period prior to 2014. At the end of the observed period, public debt would increase by about 6% of GDP. It is evident that a number of positive effects can be achieved through better control and the introduction of stricter criteria for issuing new guarantees.

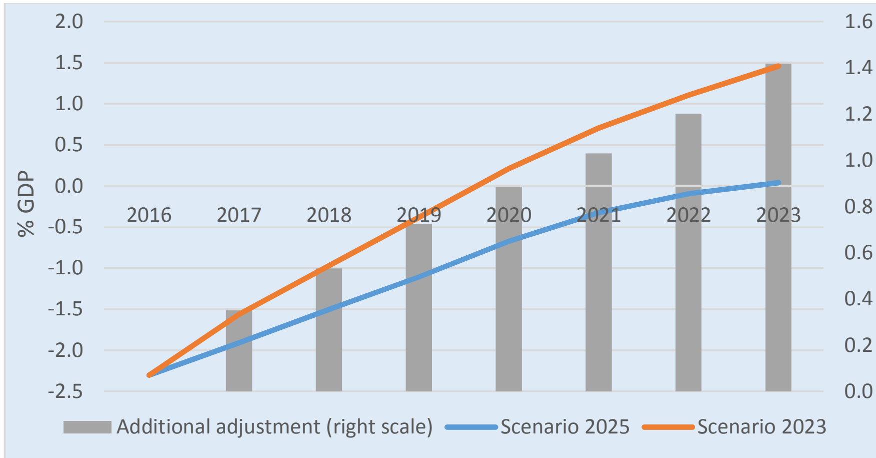
Scenario “without measures“ assumes a different path even in the period from 2013 to 2016. The initial level of debt in 2014 would rise by 6.7 percentage points, and in 2016 it would reach 77.4% of GDP. This scenario represents the worst move that implies the absence of fiscal consolidation measures and absence of additional financial flows anticipated in the baseline scenario. Funds to be used for this purpose allow partially reduced interest expenditures by changing the structure of a long or a direct impact on the required level of additional debt. The path of debt arising from this scenario is the least favourable, while other scenarios presented assume full implementation of the measures at least up to 2016, and in this way, the extent and impact of the absence of fiscal consolidation is clearly shown.

The best and fastest route lowering the debt would be secured by applying the baseline with the combination of limited guarantees issued and the use of privatization proceeds and other additional funding with the aim to reach the proposed level of debt more quickly, with fewer negative effects on the economy, population and macroeconomic environment.

By comparison, if the goal was to reduce the level of debt to 45% of GDP by 2023, it would take a stronger fiscal adjustment and achieving a fiscal surplus of 1.5% of GDP in that year, as shown in the following chart. The projected fiscal results are shown in two varieties, the baseline scenario in accordance with the program of debt reduction and alternative scenario involving lowering the debt to 45% of GDP by 2023. For this to be achieved much greater fiscal adjustment is required, or in other words, for this result to be achieved by 2023 an additional adjustment of 1.4% of GDP is required, which is about RSD 111.1 billion in that year, a total of RSD 412 billion of cumulative adjustment in the period 2016-2023. For that amount, it would be necessary to increase the revenues, reduce expenditures and create a combination of measures on the revenue and expenditure sides, which, taking in account the high amounts in question, does not seem feasible.

For this reason, the fiscal policy after 2016 must be focused on further slowdown in debt growth, by reducing the relative share of the deficit in GDP and by means of the fiscal adjustment on the expenditure side. It is important to note that the successful implementation of the programme will be aided by adequate control and monitoring of the new guarantees. Retention of guarantees issued to the level determined by this programme has as a prerequisite improving of the process of monitoring, risk assessment and prioritization of investment projects.

Graph 9. Fiscal Outcome and Additional Adjustment Depending on Public Debt Reduction Dynamics



4. Cyclically Adjusted Fiscal Balance

For cyclically adjusted deficit evaluating the approach used by the OECD and the disaggregated approach, which involves evaluating the elasticity of individual categories cyclically sensitive income and expenditures. Cyclically adjusted balance is calculated by the following formula:

$CAB_t = B_t – \eta\ (Y_t - Y_t^*)/Y_t^*$

In the above formula, η (Yt - Yt *) / Yt * is cyclical component of balance, represented as a product of the coefficient of sensitivity of balance to the output gap (η) and the estimated output gap in the year ((* Yt - Yt) / Yt *). The coefficient of sensitivity of the fiscal balance is equal to the difference between the coefficients of sensitivity of revenues and expenses η = ηT - ηG.

Multiplying the obtained elasticity of revenues and expenditures to share sensitive cyclical revenues and expenditures in GDP (period average), sensitivity coefficients are obtained by public revenues and expenditures, and revenue is estimated that ηT = 0.386 and expenditure ηG = -0.01. Overall sensitivity of fiscal balances obtained as the sum of the sensitivity of revenues and expenditures is η = 0.386 - (-0.01) = 0.387.

The results and their interpretation are largely dependent on the length of the series used for econometric evaluation of elasticity, the reliability of the statistical data, the existence of structural breaks in the series, changes in methodology and coverage, as well as the properties of the model itself.

Graph 10 shows the actual fiscal and cyclically adjusted fiscal balance for 2001 to 2013 period with projections for the period from 2014 to 2016. Looking at the past few years, the positive effect of the cycle is visible in 2007 and 2008 where there is a positive output gap. The effect of the cycle is such that it leads to the fiscal balance that is less than it would be if the economy was on a potential growth path. Conversely, most pronounced during the crisis in 2009, 2010 and 2012 the impact of the cycle is negative, the output gap reaches a relatively high negative values, and the actual fiscal deficit is significantly higher than cyclically adjusted fiscal deficit.

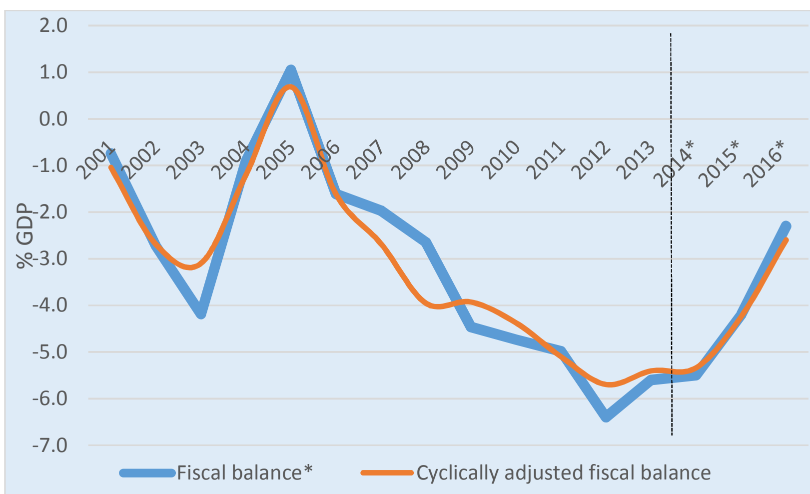
Table 12 2001 – 2016 Fiscal Balance and Cyclically Adjusted Fiscal Balance Calculation Components, as % of GDP

	Output gap*	Fiscal balance**	Cyclically adjusted fiscal balance	Cyclical fiscal balance	Nature of fiscal policy (fiscal impulse)
2001	0.8	-0.7	-1.0	0.3	/
2002	-0.1	-2.7	-2.7	0.0	1.7
2003	-2.8	-4.2	-3.1	-1.1	0.4
2004	0.7	-0.9	-1.2	0.3	-1.9
2005	0.9	1.1	0.7	0.4	-1.9
2006	0.0	-1.6	-1.6	0.0	2.3
2007	1.8	-2.0	-2.7	0.7	1.1
2008	3.4	-2.6	-4.0	1.3	1.3
2009	-1.4	-4.5	-3.9	-0.5	0.0
2010	-0.9	-4.7	-4.4	-0.4	0.4
2011	0.3	-5.0	-5.1	0.1	0.7
2012	-1.8	-6.4	-5.7	-0.7	0.6
2013	-0.5	-5.6	-5.4	-0.2	-0.3
2014*	-0.4	-5.5	-5.3	-0.2	-0.1
2015*	0.1	-4.2	-4.2	0.0	-1.1
2016*	0.8	-2.3	-2.6	0.3	-1.6

* Output gap calculated with Hodrick-Prescott filter

** Projected values

Graph 10. 2001 – 2016 Real and Cyclically Adjusted Fiscal Balance, as % of GDP



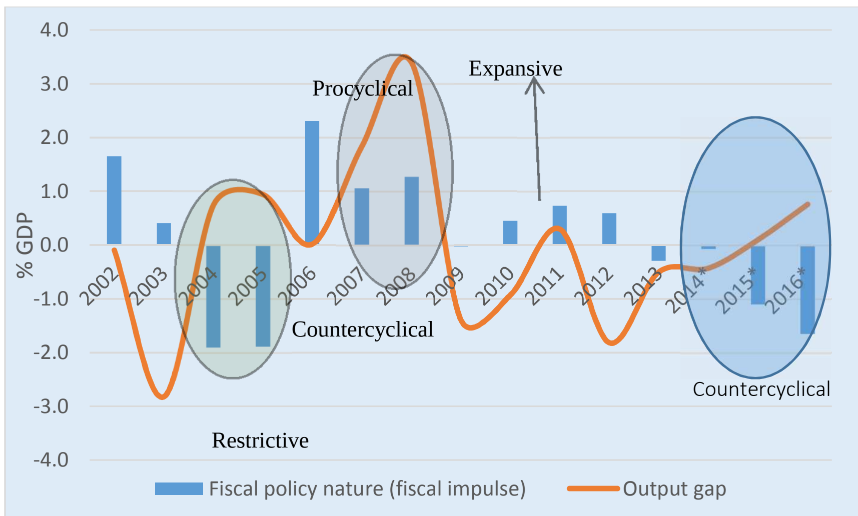
* projected values (2014 - 2016)

In the period from 2013 to 2016, GDP growth rates will near the potential ones and the output gap will slowly narrow, with a positive value achieved in 2015. A consequence of the positive effects of the cycle is reflected in the lower value of the actual fiscal deficit relative to cyclically adjusted fiscal deficit.

Cyclically adjusted deficit movement is used as an indicator of fiscal policy. The last column in Table 12 shows the fiscal impulse obtained as the difference between cyclically adjusted deficits in the current year and the previous year. A positive prefix indicates an expansive fiscal policy, while a negative prefix indicates a restrictive fiscal policy.[7] Graph 11 shows periods of expansive and restrictive fiscal policy, as well as the size of the impulse itself.

When the output gap is included in the analysis, it is possible to evaluate the effects of fiscal policy in terms of its pro-cyclicality or counter-cyclicality. Pro-cyclical policies are characterized by the presence of an expansionary fiscal policy in periods of growth above the potential level (or restrictive policy in a recession), and vice versa. As a result of pro-cyclical fiscal policy, changes in expenditures follow the movements of GDP, before they are a consequence of the planned policy. If the actual growth in real terms exceeds the potential level, the cyclically generated component of revenue growth is then used to reduce the tax burden or increase spending, rather than to reduce the fiscal deficit.

Graph 11. 2002 – 2016 – Fiscal Policy Nature and Effects



* projected values (2014 – 2016)

A counter-cyclical policy was implemented between 2009 and 2011, during the crisis, given the relatively expansionary fiscal policy in terms of growth below the potential level. Such behaviour appears economically logical at first glance, whether it is done deliberately or as a result of the structure of the tax system and public expenditures. However, as a result of an expansionary policy, which has not resulted in faster growth, and in situations when fiscal policy measures alone cannot eliminate the structural reasons for the negative output gap and growth (decline), the real and cyclical adjusted balance will deepen and public debt will enter an expansion stage.

[7] It would be methodologically correct to include the cyclically-adjusted primary balance as a measure of the fiscal impulse, but this approach will also give an objective presentation of the nature and influence of the fiscal policy. There are, of course, various restrictions on the use of the cyclically-adjusted deficit in the assessment of the effects of fiscal policy in this context, so caution is advised when making any final assessments.

A negative output gap will exist from 2013 to 2014, but it will be closed in 2015. This reduction is driven by a slight acceleration in real growth, however, this is not enough to automatically lead to a reduction in actual and cyclically adjusted deficits. From the graph it can be seen that a relatively significant structural adjustments made during the 2013 were due to changes in tax policy at the end of 2012. The full effects of the measures will not be demonstrated in the 2013 but it will also be transferred to the next period, which will give some impulse to restrictive fiscal policy.

Measures to limit the growth of salaries and pensions in the period 2014-2016, although of limited duration, will have certain effect in term of structural change because they will create savings by reducing the basis future indexation of these expenditures. In other words, savings achieved in this period will be carried forward to the following years as a permanent measure. On the other hand, in 2014 the projected interest payments and capital expenditures for infrastructure projects will increase to a certain extent. This will weaken the effects of savings on current expenditure and a relatively small effect of the negative fiscal impulse. Among other things, mid-2014 will see the end of restructuring of SOEs and the cessation of payment of funds for subsidies to these companies, and on the other side appears an additional cost in the form of repurchase claims related to the employment of these companies, thus saving in 2014 was effectively neutralized. It should be noted that the calculation of the structural deficit should exclude all temporary and one-off measures. This would provide a clearer picture of the extent of structural adjustment in 2014, especially as the projected increase in the lower VAT rate can be regarded as a permanent structural measures.

A combination of measures envisaged by the programme of fiscal consolidation in the period 2014-2016 at first glance should show the greatest structural effects in 2014. Due to these reasons, it is not happening for the highest level of restrictive fiscal policies is felt in the future, when there is a stagnation of capital expenditures and interest expense. Transferred together with the effects of the slow growth of salaries and pensions in the previous year, as well as the effects of the reform of public sector salaries, which leads to the tightening of fiscal policy in the 2016 were increased compared to the previous year.

Throughout the period from 2013 to 2016 the specific effects of fiscal adjustment and the contribution of fiscal policy restrictiveness is legally provided for an increase in the excise tax on tobacco products and petroleum products, as well as some degree of increased efficiency in revenue collection at central and local levels.

Approaching the actual growth rate potential level reduces, to a certain extent, the need for restrictive fiscal policy. In the context of the stabilization of the public debt, the effects of cost-saving measures in the period lead to its stagnation and a slight decrease, but for a serious reduction in the public debt to GDP ratio it is necessary to continue with fiscal consolidation measures after 2016. Real, above the potential, GDP growth would enable the process to be facilitated in the long term.

5. Public Debt Management

Pursuant to the Public Debt Law, the primary objective of Serbia`s borrowing and public debt management is to ensure funds needed to finance budget expenditures, with minimum mid- and long-term financing costs and with acceptable risk levels. Minimization of long-term costs of servicing the public debt is limited by the structure of debt, and the actual cost reduction will depend on a number of factors and risks. Taking this into account, the Public Debt Management Strategy of the Republic of Serbia identifies the following overall objectives and principles:

1) It is necessary to ensure financing of Serbia`s fiscal deficit, including both the short-term (liquidity) and long-term deficit, as a part of the policy aimed at maintaining the public finance system stability;

2) It is necessary to define the acceptable level of risk, which should be determined as a targeted debt portfolio structure in terms of currency structure of debt, interest rate structure, maturity structure and debt structure by types of financial instruments;

3) Support should be provided for the development of a market for government securities issued in domestic and foreign markets in order to utilize the developed markets as a means of cutting borrowing costs in the mid and long term, in line with the high-quality diversification of the debt portfolio;

4) The borrowing process should be transparent and predictable.

At the end of August 2013, total public debt stock stood at RSD 2,245.6 billion or 59.7% of GDP. Out of that amount, direct obligations accounted for RSD 1,861.0 billion, indirect liabilities accounted for RSD 330.2 billion whereas non-guaranteed local government debt accounted for RSD 54.4 billion. Internal direct liabilities amounted to RSD 747.9 billion, while external direct liabilities amounted to RSD 1,113.1 billion. As regards indirect liabilities, internal debt stood at RSD 95.5 billion, while external debt reached RSD 234.7 billion. If broken down into internal and external public debt, total public debt amounted to RSD 883.3 billion and RSD 1,362.3 billion, respectively. According to the figures as at 31 August 2013, the bulk of Serbia’s public debt remains denominated in euros (48.8%) of total public debt stock. This is followed by public debt denominated in US dollars, with 25.8% and dinars with 19.0%. The remaining debt is denominated in Special Drawing Rights (4.9%) and other currencies (1.5%). The majority of Serbia’s public debt (71.7%) is subject to fixed interest rates, while debt with variable interest rates accounted for 28.3% of total public debt.

Taking into account Serbia’s projected primary budget deficit in the period 2013-2016, including the disbursement of loans for project financing of budget beneficiaries, the effects of exchange rate changes between the dinar on the one side and the euro and the US dollar on the other side in the basic macroeconomic scenario, the balance of Serbia’s public debt should equal about 68% of GDP, at the end of

2016, assuming that a portion of state-owned assets will be sold in the forthcoming period.

Table 13 Basic projection of general government debt by 2016

	2013p	2014p	2015p	2016p
	in RSD bln			
GDP	3,761.3	4,007.8	4,292.1	4,583.7
Primary deficit	96.5	70.3	17.9	-59.0
Interest	91.7	112.4	106.5	127.1
Public debt	2.358.6	2,634.2	2,925.0	3,114.4
Central government debt,% of GDP	62.7%	65.7%	68.1%	67.9%
Non-guaranteed local government debt, % of GDP	1.5%	1.5%	1.7%	1.8%

According to the projections, local government debt will remain at a relative level of about 3% as a share of GDP. Debt arising from guaranteed liabilities, which are not included in public debt balance according to the Maastricht criteria, is expected to be around 3% of GDP.

In cooperation with World Bank experts, the Public Debt Agency of the Serbian Ministry of Finance applied the WB Medium Term Debt Strategy Model (MTDS) as a cost and risk analysis for the purpose of portfolio optimization and more efficient public debt management.by using the MTDS model, baseline and three alternative scenarios were analyzed (four analyzed strategies). Shocks regarding interest rates and exchange rates were also taken into account (sensitive analysis).

Financial and fiscal risks can lead to public debt increase larger than envisaged by the basic scenario. The risks that are present and that can lead to the growth of debt and costs of public debt servicing are:

1. Refinancing risk;
2. Roreign exchange risk;
3. Market risk (interest rate risk, inflation risk);
4. Liquidity risk;
5. Credit risk;
6. Operational risks;
7. Risks linked with the distribution of servicing costs (debt structure, concentration of obligations).

The key risks to the Strategy implementation, that are quantified, in addition to the above specified ones, are also: stability of the macroeconomic situation in Serbia (real GDP growth, tax collection, unemployment rate, current account of payment balance, interest rates on the domestic market, inflation, exchange rate of the dinar against the euro, etc.); development of the world economy and Serbia`s principal foreign trade partners; needs for additional borrowing in order to regulate the debts at other levels of government, in public sector and financial system of Serbia; tax and non tax revenues lower than planned and expenditures larger than planned during the budget year; significant decline in the value of the dinar against the euro; higher degree of borrowing by local authorities than planned in the medium-term macroeconomic (fiscal) framework; activation of provided guarantees.

Taking into account the above mentioned limitations and potential risks, it was nevertheless decided that the public debt management strategy in the following mid-term period should focus on financing national budget expenditures mainly through the issues of government securities in international and domestic capital markets. The aim is to finance the debt in the following long-term period through the issues of mainly dinar-denominated securities in the domestic market. However, the current situation indicates that despite a strong commitment to develop the domestic market for government securities, a large share of financing will have to be ensured in the following mid-term period in the international financial market Public debt management policy must take into account the long-term perspective, but the decision on financing the budget expenditure must be made on an annually basis. Decisions on annual borrowing are made within the framework of the Budget Law for the fiscal year concerned, and are the subject to change during the fiscal year covered by the borrowing plan if basic fiscal aggregates change.

Republic of Serbia should support the development of domestic market. If the planned activities regarding the issuance of long-term dinar bonds would be accomplished, the yield curve of government securities denominated in dinars would be determined by the end of 2014. In the period for which this strategy is adopted, it is also expected that the secondary market for government securities improves, resulting in the transparent yield curve on dinars and improvement of the dinar portion in financial market, enabling thus the Government of the Republic of Serbia to finance its expenditures more efficiently and with a less exposure to the foreign exchange and other risks. A plan for extending the average maturity of the dinar denominated securities depends on a series of factors, but primarily on the success of the NBS and the Government in the process of dinarization and in maintaining inflation within the set frameworks along with the rise of confidence in the monetary and economic policies of the Government and the NBS, and on the stability of the dinar exchange rate.

6. Fiscal Risks

The public finances of the Republic of Serbia are facing a number of risks in the medium term. Fiscal risks are deemed to be circumstances which, if implemented, could result in significantly lower revenues or increased expenses. The envisaged volume of revenues and expenses is dependent upon the success of fiscal policy to minimize the probability of risk. The success of risk management depends on political, macroeconomic and social conditions in the country and the region.

The decline in economic activity. The negative scenario in the future means economic decline and lower growth, has led to drying up of capital, reduction of foreign trade, and the reduced activity of a narrowing of the current account deficit. In this case, there would be less revenue, and consequently a larger deficit, if it would not work on additional adjustment on the expenditure side. If you achieve a negative scenario in section 2.4 of this document, the deficit would be higher by 0.4% of GDP in 2014, and by 0.7% of GDP in 2016, compared to the baseline scenario.

Interest. Expenditures for interest, apart from the amount and structure of the public debt, are affected by exchange rate and international interest rates. Given the unpredictability of the movement of individual variables it can increase the required funds for interest in the future. A significant part of the public debt belongs to guarantees issued for the loans of public companies. If the company can meet their obligations no additional resources are needed, but these guarantees do increase the public debt level. If the company cannot meet their obligations guarantees would be activated, so additional resources for repayment of loans and interest payment would be needed.

If there would be no anticipated privatization inflows and favourable borrowing funds in the period 2014-2016, in the pessimistic scenario is envisaged that the cumulative interest loans would increase by RSD 56 billion or 1.3% of GDP in this period.

The shadow economy. Programme of Fiscal consolidation measures is aimed at further efforts to combat tax evasion and the shadow economy. If these measures don't succeed there is a possibility of losses on the revenue side of over RSD 16 billion a year.

Unspent funds from previous years. In the past years at some levels of government significant unspent funds were formed at the approximate amount carried over to the next period and so they do not distort the fiscal outcome. However, if a decline in liquidity and weaker collection of current revenues would occur it may have caused accelerated wear of these funds and increased fiscal deficit. Although the impact on the overall level of the deficit generated by this part of the fiscal results does not affect the level of public debt at the time of its creation, it can have negative effect on the level of liquidity in the future, and to some extent can create a false picture of the state of public finances.

Project loans. Project loans are a key source of funding for major infrastructure investments. Funding these loans are included in the calculation of the fiscal results, mostly as capital expenditures. Although faster disbursement of these funds is not bad from the standpoint of the economy and should encourage greater economic activity and dynamic development, it increases the expenditure side of the budget and deficit.

Public-private partnership (PPP). Comprehensive assessment and risk management in all phases of the implementation of public-private partnerships, multi-year budgeting of the projects, precise timing of all future costs in the public sector, the analysis of indirect liabilities and risks of their activation are prerequisites for reducing exposure to public finance risks arising during the implementation of these projects. The Government's decision to establish the Commission for a public-private partnership is envisaged that the project cannot be implemented without a positive opinion of the Commission, and the Commission cannot give a positive opinion without a positive vote of the members of the Commission who represents the ministry in charge of finance. Also the methodology for calculating the values obtained for the money (value for money) is prepared, in order to prove the advantage of the project through a public-private partnership in relation to traditional procurement, including the quantification and allocation of risk.

IV. STRUCTURAL REFORMS IN THE PERIOD 2014 – 2016

A credible midterm plan for structural reforms, along with the fiscal consolidation measures, is the key condition for (1) the implementation of stabilization of public finances and bringing fiscal deficit and public debt down to a sustainable level, (2) more powerful mobilization of economic activity based on the increased investments, exports, and employment. With this announced measures projected fiscal and structural adaptation will be implemented, and that will create a longer lasting basis for more rapid growth and an increase of employment and living standard.

Implementation of the plan for structural reforms means that relevant state ministries will finish preparations and commence implementation of the structural reforms in the areas of their jurisdiction by the end of 2013.

1. OBSTACLES TO ECONOMIC GROWTH AND STRUCTURAL REFORM PLAN

The economic crisis has highlighted the structural weaknesses of Serbian economy and obstacles to the country's sustainable economic development. The main obstacles to economic growth include:

- Excessive government interference with the economy;
- Administrative barriers and regulatory restrictions for business operations;
- Lack of competition in certain sectors;
- Insufficient infrastructural capacities;
- Structural inflexibility of the labour market;
- Large share of informal economy.

To eliminate these structural obstacles to growth, Serbia is shaping its transition towards integrated, smart, sustainable and inclusive growth, supported by good public governance, which increases prosperity and generates new employment through fast and stable growth and stronger EU integration. To that end, it is necessary to reduce the role of the government in the economy and provide and implement regulations that would improve the functioning of the market, eliminate administrative and regulatory obstacles in the market, strengthen competition and improve the goods market and reduce youth and structural unemployment, while at the same time promoting sustainable growth of employment through generation of new jobs, modernisation of industrial infrastructure and reduction of the volume of informal economy.

Reforms in the public sector are aimed at reducing the role of the government in the economy and increasing its efficiency in the achievement of the society's overall objectives. This will allow for better fiscal adjustment, in particular on the expenditure side, through lower deficits and less need for borrowing. It is of particular importance to reduce the number of government-controlled companies, to reduce the volume of regulated prices, to reduce state aid, to cut costs across the public sector etc.

In parallel with this, it is necessary to build the sustainability of the private sector, which generates growth perspective for the economy and the society as a whole. A key role in this will be played by improvements in the business and investment climate to reduce the costs and risks associated with operations and investments in Serbia, completion of restructuring of state-owned enterprises, faster company start-up procedures and more efficient enforcement of bankruptcy legislation. It is also necessary to improve competition protection, support faster development of small and medium-sized enterprises and entrepreneurship and eliminate inflexibilities in the labour market.

Crucial for strengthening of the private sector will be faster and timely completion of restructuring and privatisation of the remaining enterprises in the portfolio of the Privatisation Agency, within the time limits set by the law, based on an analysis and assessment of their economic viability. It is also necessary to expedite the restructuring and privatisation of public enterprises to improve their corporate governance and increase their efficiency, after which some of them should be privatised by attracting strategic investors.

Administrative and regulatory obstacles at national and local levels impose unnecessary costs of doing business and reduce legal certainty. It is therefore necessary to continue the “regulatory guillotine”, simplification of administrative procedures, improvement of financial discipline, facilitation of market exit, simplification and shortening of procedures for obtaining building permits and speeding up of land expropriation as an obstacle to implementation of infrastructural projects.

Lack of competition in key industrial sectors undermines the competitiveness of the economy. To increase competition, it will be necessary to regulate monopolies, strengthen the capacities of the Competition Protection Commission and cut government subsidies to various sectors. Strengthening of competition will imply gradual liberalisation of regulated prices, reduction of state aid in the form of subsidies, tax incentives, favourable loans and guarantees and a shift to horizontal forms of state aid.

The existing rigidity and limitations of the labour market need to be addressed through a reform of labour legislation in order to support sustainable employment. The aim is to increase flexibility and mobility in the Serbian labour market. Adjustment of teaching curricula and syllabuses to the needs of the labour market and increased quality of knowledge acquired in the education system would bring about to an improvement in the labour market.

The sectors which have been identified as pillars have seen certain improvements, but infrastructural obstacles to economic growth persist. Faster economic growth is hampered by the overall situation and problems in the fields of transport, energy, telecommunications and information technologies. Addressing these obstacles will require considerable funding for infrastructure and vehicles in the field of transport, infrastructure and capacities in the field of energy – especially renewable energy – and infrastructure for all types of electronic services. Given the high level of public debt and the large number of projects competing for funding from public sources. It will be necessary to improve the methodology for evaluation and selection of priority projects (on the basis of standard cost-to-benefit analysis) and to consider various alternative (non-lending) modes of financing the implementation of certain infrastructural projects.

Taking into account the high volume of informal economy in Serbia – approximately 30% of the GDP – it is necessary to continue the systemic combat against informal economy through improved functioning of the tax administration and detection of tax evasion, reduction of the number of tax procedures and their simplification, improved taxpayer control, more efficient tax control and collection, cross-checking of property and income and improved operation of the inspectorates.

Elimination of structural obstacles to economic growth will require a credible structural reform plan and an active structural policy. Any delay in structural reforms would pose a huge risk for the achievement of economic and fiscal policy objectives. The planned fiscal adjustment in the next three fiscal years cannot be achieved by fiscal consolidation measures alone, without reforms. The commencement of reforms is scheduled for 2014. Credibility of the structural reform plan will depend on timely and consistent implementation of the envisaged reforms. To that end, starting from the medium-term reform plan set out in the Fiscal Strategy, the competent national ministries will make specific action plans on implementation of reforms in their respective fields of competence. Operationalization of reform intentions and acceleration of structural reforms would result in higher productivity and would set growth on a path of sustainability. An overview of the planned structural measures and key policies aimed at eliminating the structural obstacles is given in item 2 of this PEP chapter.

2. The main structural reforms

2.1. *Business environment reform*

Acceleration of economic growth represents a basic mechanism for continuous and sustainable increase of employment. In relation with this, in 2014, numerous reforms shall be conducted with the objective of diminishing risks and cost of employment. The results of relevant international analyses of competitiveness and business conditions (The Report on Competitiveness by the World Economic Forum, The Analysis of the Conditions for Doing Business by the World Bank) shall be utilized in identifying the key measures for an improvement of the conditions for doing business. Establishment of the Office for quick responses represents a step forward towards simplifying and accelerating the procedure start-up. Related to this, the focus in the upcoming years will be on the following reforms:

- *Adoption of amendments to the Labour Act* in order to increase the flexibility of the labor market in Serbia and to simplifiy the procedures for ease of hiring and firing labor. To this end, amendments would eliminate the systemic deficiencies of the labor market and introduce contemporary mechanisms for protecting workers and stimulating employment, and reduce employers' costs in the event of redundancy;
- *Adoption of the new Law on Planning and Civil Construction*, starting from the efficient solutions implemented in other European countries, along with

stronger combat against various abuses in the institutions that are in charge of its application on the local level;

- *Adoption of the new Law on Privatization* to correct systematic deficiencies of the prevailing model of privatization and the introduction of new mechanisms to speed up the completion of the privatization process in Serbia. These changes will ensure full transparency of the privatization process and the responsibility of public authorities, will determine the final deadline for the privatization, will regulate social capital transformation in the state capital, and establish rules of restructuring;
- *Amendments to the Law on Bankruptcy* aiming at the improvement of efficiency (duration and cost) of the bankruptcy procedure. Amendments will ensure full transparency of the bankruptcy proceedings, will strengthen the position and increase accountability of trustee, introduce analysis of the causes of bankruptcy, will increase creditors' rights and increase employment in companies in bankruptcy through the connection of years of service and the right to a minimum wage;
- *Improvement of fiscal discipline*, representing a precondition for the efficient curbing of grey economy. In relation to this, measures for compensating arrears of the state, on all levels, will be activated;
- *The continuation of tax reform for development of tax legislation to ensure the introduction of the concept of reform that will have the greatest impact on increasing investment, exports and employment;*
- *Finishing up the process of introduction of electronic(on line) submission of tax return forms and single tax return form* in order to have one single form for all taxes and contributions which will be paid to one account;
- *Intensifying the "Guillotine of Regulations"* based on the detailed action plan that will be adopted.

Labor Legislation Reform

One of the principal goals of all structural reforms is an increase of the employment rate. In relation to this, in the upcoming period, the reform of the institutional framework for the labor market functioning will be carried out, so that its flexibility will be increased and employment will be made less expensive and less risky for employers. In those terms, the labor market reform will be carried out in two steps - by the end of 2013, the Labor Law will be amended in order to eliminate its most significant shortcomings, and in the course of 2014, additional changes to the Labor Law and other relevant regulations will be made in cooperation with trade unions, representatives of the associations of employers, and expert public, all in order to remove the identified shortcomings and to incorporate modern mechanisms for the protection of workers and to provide incentives for employment.

Amendments to the Labor Law, which will be adopted by the end of 2013, will include the following:

- Change of the calculation mode of severance, so that the severance in case of technical surplus of the working force will be calculated for the number of working years with the existing employer. To minimize the room for abuse of this rule, the protective mechanisms for workers will be envisaged, so for the severance calculation, the number of working years with the existing employer will be considered, including those years with all linked persons/entities;

- Increased flexibility of the mechanisms for termination of employment, so that the obstacles for temporary employment of workers will be removed, and to affirm possibilities for redistribution of working hours, etc.

Apart from this, in 2014, some options will be considered to introduce additional mechanisms for the protection of workers and to provide incentives for inclusion in the labor market and employment, which will, among other things, include the reform of collective negotiating, regulation of the legal framework for self-employment, and a possibility for the implementation of the measures from the EU Program for employment and social policy will also be taken into consideration, as well as a possibility for introducing the incentives for inclusion in the labor market (labor benefits), etc.

Parallel to the legislation reform, the activities on the improvement of efficiency of inspection services (the Labor Inspection above all) will be intensified in order to strengthen supervision over the implementation of the new, more flexible, provisions of the labor legislation.

The Reform of the System for Issuing Construction Permits

One of the priority activities for the improvement of business environment in the country is to simplify and shorten the procedure for issuing construction permits. The objective is to provide easier and more inexpensive obtaining of construction permits, which calls for the adoption of the new Law on Planning and Civil Construction.

The process of obtaining construction permits now is non-transparent, long, and burdened with bureaucratic procedures and it is very often a source of corruption. Therefore, it is necessary that investors receive construction permits within one or two months on the entire territory of the Republic of Serbia under the condition that the construction site is covered with the planning/project documentation. It is also necessary that the permits are obtained on one spot, which means that the applications are submitted to a certain office and the employees of the urban planning department should internally (ex officio) provide approvals and opinions of other departments, including the opinions of public enterprises, which are obtained at the time of the designing of the detailed regulation plan. The approval of public enterprises will be still needed for the structures being built in the area that is not covered by the detailed regulation plan.

Shorter period of time for the obtaining of construction permits will be possible because the constructors will not be obliged any more to submit approvals and opinions of the public enterprises for water supply, sewage, and electric power because all opinions of public enterprises have already been obtained at the time of the developing of detailed regulation plans. It is estimated that the exclusion of public enterprises from the decision making process should shorten the construction permit obtaining procedure for at least three months, so the investors will not be in a position any more to address public enterprises three times in order to obtain technical conditions to develop the design, to obtain their approval for the design, and to obtain approval for the use of the structure.

2.2. Structural Reforms of Public Sector

In order to establish long-term sustainability of public finances, the implementation of the structural reforms of public sector should be speeded up, referring, in the first place, to the public administration system, educational system, the health care system, the pension system, the social protection system, the restructuring of state owned and public enterprises, the subsidy system, the public finances management, local public finances management and tax system reform.

State Administration Reform

State administration reform will be carried out in line with the State Administration Reform Strategy. This will lead towards the improvement of the adopted legal framework and the improvement of all parts of public administration systemin line with European standards and values in the area of public affairs.

Structural changes are necessary in all segments of public administration, which encompasses state administration, local self-government, and public services and their key administrative functions. The objective of the state administration reform is to provide rational, accountable and sustainable public administration, which will be professionally capable and efficient in performing public work. For that purpose, public administration reform refers to:

- Completion of the legislative framework and application of the adopted legal provisions regulating public administration system;
- Improvement of strategic planning system and coordination of public policies and their better linkage with the program budgeting;
- Reorganization of public administration and rationalization of the public administration system;
- Improvement of the state administration productivity through a reduction of the number of employees on the central and local level -- in those segments where the number of employees departs from the estimated needs;
- Better coordination between central and local level of public administration and better quality of public policies and regulations as a result of such coordination;
- Certain delegation of authorities to lower levels of the administrative system, completion of administrative procedures and disputes, more efficient administrative disputes, better administrative decision making and better quality of administrative services;
- Capacity building of the state administration staff, improvements in salary system and in evaluation and promotion procedures for civil servants through affirmation and improvements of the remuneration system based on performance;
- Revision of criteria for hiring staff in the state administration, as well as specifying criteria for promotions in order to curb phenomenon of hiring and promoting staff in a short period of time, based on formally obtained higher education degree, without acquired expertise and competences that are necessary to complete tasks;
- Strengthening the financial control mechanisms and elevating quality of public procurement, development of e-administration, curbing corruption in the

administrative system, strengthening mechanisms for the protection of citizens' rights, including the function of Ombudsman.

In the area of state administration, it is necessary to complete the legal framework and strictly implement the adopted regulations. For further reforms of state administration it is necessary to complete the legal framework by adopting the new law on general administrative procedure, the law on the status of local self-government employees, and the law on salaries of local self-government employees as the laws on status and salaries of civil servants are not applied on local self-government employees.

At the same time, it is necessary to ensure better functionality of the state administration system through elimination of the same or similar jobs within the mandate of state administration bodies on the national or local level, as well as in various organizational forms of other entities that are entrusted with public authority. Also, it is necessary to simplify administrative organization through the reduction of the total number of state administration bodies on the national and local level, as well as entities of public law that are entrusted by law with administrative (public) authority (e.g. public agencies, public funds). For that purpose, an analysis will be carried out to determine if it is justified for public agencies and public funds to exist in particular administrative areas, as well as for other forms of public authority carriers (councils, commissions).

Within the public administration system, activities of public agencies, public funds, and other forms of public interest implementation will be legally regulated in an appropriate way and harmonized legal status of their employees will be provided along with efficient control of state administration over performing the entrusted tasks to the public authority carriers.

Within the state administration reform, reform activities will be carried on for the improvement of the functioning of local self-governments. Decentralization on the local self-government level in Serbia will be improved in order to enable citizens to participate in managing local self-government's affairs and make beneficiaries of local self-government's services satisfied with its work. Also, the process of de-politicization of public administration will be carried on aiming at the diminishing of political influence and the level of discretion right decisions of the local self-government's bodies in performing their authorities.

The public administration reform, beside state administration and local self-government, will include improvements of the functioning of public services, which are founded by the Republic, Autonomous District and local self-government unit, such as public institutions, public enterprises, and other forms of public services (bureaus, centers, and others). The goal of this reform is to improve performance of public services in organizational and functional terms and to diminish influence of political parties on these services. It is necessary to improve legislation in this area, the relationship between founders of public services and public services bodies, between public services and their users, public services funding system, etc.

Educational System Reform

Consolidated expenditures on education in Serbia amount around 5% of GDP, and they are at the average level of the CEE countries. However, considering on the structure, expenditures on primary and secondary education in Serbia (as a percentage of GDP) are substantially higher than in CEE, while spending on public higher education are significantly lower. The results of the education system are measured on the basis of education coverage and quality of the knowledge acquired. Comparative data indicate that the coverage of primary and secondary education in Serbia is higher than the average of CIE, but still lower than the EU average, while coverage of the higher education system is significantly smaller than the average CEE and EU. Regarding the results of the Serbian education system, although there are no standard approaches to its measurement, in practice, this issue is frequently discussed based on the results which students from different countries realize through the standardized PISA tests. According to the latest results, students from Serbia took 45. place (among 65 countries), with the average number of points significantly lower than the EU average and a moderately lower than the average of CEE countries. When it comes to higher education in Serbia, there are seven public and seven private universities, of which only one (University of Belgrade) is in a group of 400 best universities in the World (out of a total of about 20,000 university). The next relevant university ranks in the group from 1,000 to 1,500 the best in the world (University of Novi Sad), while the top-ranked private university is located in a group of 5 to 10 thousand best . These results also indicate a low level of efficiency of higher education in Serbia.

The above data indicate that the structure of expenditure on education in Serbia is inadequate (80% are employee wages), although total expenditures for education are not low, so there is considerable scope for improving the educational performance (coverage and quality). Proceeding from the above, the reform of the education system in Serbia in the future will be focused on:

- The savings on expenditures by rationalizing the school network , which is inherited from the period of four decades ago, when the number and geographical distribution of students was much different than today. In addition, data on the relationship between the number of pupils per teacher in primary and secondary education in Serbia and CEE showed relatively low levels of productivity in education in Serbia. Consequently , the number of classes and teaching and non-teaching staff will match the rate of enrollment in primary and secondary schools and, if necessary, shall be joining classes at schools that do not have a sufficient number of students . The savings that will be achieved by rationalizing the school network will be partly used to increase spending on public higher education in order to increase the number of students studying at the expense of the state budget (especially in engineering) , thereby increasing the scope of the higher education system in accordance with education development Strategy in Serbia until the 2020th;
- Improving the quality of education will be encouraged through the introduction of schools ranking according to the results their students achieve at the final (or other, specialy organized exam), and by rewarding employees in those schools

whose students achieve above average results and sanctioning of employees in schools whose students performed worst results. In addition, adjustments will be made teaching and curricula needs of the modern labor market . The special importance of active participation in the labor market is improving the quality of secondary education and the quality of public and private university education, as well as harmonization of demand for skilled labor and supply. In this regard, the role of the state will be to encourage and systematically improve the quality of programs and teachers in the public education system and to significantly strengthen preventive regulatory function of private education.

Healthcare System Reform

In line with the adopted strategic documents and system legislation in the area of healthcare, activities will be continued on the reforms that provide an increase of efficiency of healthcare system, an increase of fiscal sustainability of the healthcare system, an improvement of general population health, and an improvement of healthcare quality. It is possible to implement these goals by switching from curative to preventive medicine and through the improvement of accreditation and certification of healthcare institutions, and through the establishment of a system of mandatory certification of minimum standards (e.g. patients' safety).

Within fiscal consolidation, rationalization of healthcare system will be conducted, first of all through reduction of non-medical staff, improvement of mechanisms for selection of priorities regarding provision of the new equipment, and better control of expenditures for medical services. In this way, the efficiency of healthcare institutions will be elevated, validation of their real performance will be provided, and the quality of healthcare will be improved. Based on this, significant savings are expected, as well as decrease of corruption in healthcare, and provision of more funding for healthcare modernization -- superior medical equipment in the first place.

In line with the new payment method for healthcare services in public healthcare institutions (with which the Health Insurance Fund - HIF - has entered contracts for provision of healthcare services), a transfer from the cost based method of funding to the payment for services that are provided on the primary level of healthcare by a selected doctor using the *per capita* model, and on the secondary and tertiary level of healthcare using the DRG model. The National Healthcare Account will be established for a better insight into the cash flow in healthcare system (payments from the Budget for healthcare, private healthcare, donations for healthcare).

Healthcare staff profiles in healthcare institutions that are funded from mandatory health insurance will be adapted to the real needs of healthcare system within available funds. At the same time, the number of inadequate non-medical staff will be reduced and the number of medical staff will be increased (MD specialists in the first place) as needed for treating and taking care of patients and for introduction of the new healthcare technologies.

In line with amendments to the Law on Health Insurance, the funding of procurement of drugs, medical equipment, and medical supplies will be reformed through the establishing of the centralized public procurement and, if needed, by developing other measures in order to prevent creation of new debts and to make savings for HIF with more liquidity in business activities of pharmaceutical industry and stable functioning of the healthcare sector.

Better collection of the healthcare contributions and the improved functioning of HIF will enable elimination of arrears to the pharmaceutical industry and regular supply of drugs on the market. The Law on Deadlines for Execution of Payments in Commercial Transactions envisages shortening of those deadlines for HIF dues and obligations (150 days in 2013, 120 days in 2014, and 90 days in 2015). Creation of electronic records as a central software system (to which all healthcare institutions will be linked with medical files of all patients in the country) will significantly contribute to the savings in healthcare sector.

Pension System Reform

The expenditures for pensions in Serbia amount to 14% of GDP and they are almost the highest in Europe (similar expenditure levels only have Italy and Austria), and it is by over 4% of GDP (1.6 billion Euros annually) higher than the average in the countries of the Central and Eastern Europe (CEE). The Pension Fund's (PIO) revenue from contributions (payments) is not sufficient to fund pensions, so the PIO deficit amounts to around 6.4% of GDP. This deficit is funded almost exclusively by transfers from the budget of the Republic of Serbia. This leads to a conclusion that the deficit in the pension and disability system is one of the principal reasons of a high consolidated fiscal deficit in Serbia and based on that, it is not possible to provide long-term sustainability of public finances of Serbia without reforming the pension system.

Factors on which the amount of PIO's deficit depends are: the ratio between the number of the employed and the number of retirees, the amount of salaries of the employed, and the contribution (payments to the Fund) rate for the pension and disability insurance, the amount of pensions, retirement requirements. The amount of salaries, on which contributions are calculated, as well as the number of the employed cannot be increased much in short-term, but the growth in that area will be happening gradually and only if the reform of public finances and business environment is implemented in such a way that it will give an incentive to more dynamic growth of GDP in forthcoming years. The contribution rate for payments for the pension and disability insurance in Serbia amounts to 24% (total rate for all contributions amounts to 37.8%), which is relatively a heavy burden for labor, discourages employment and encourages illegal work in informal economy, which leads to a conclusion that its further increase (in order to decrease PIO's deficit) will have a negative impact on the future economic growth and employment. Although there is some room to curb fraud in payments to the Fund, the effects of systematic measures for curbing informal economy can be realized only in midterm and their value will be less than the PIO deficit. Thus, the reform of the pension system, which should provide its long-term sustainability, has to refer to the other quoted parameters of the pension system, in the first place to the amount of pensions (in relation to salaries and GDP from where they are funded), retirement requirements, and the system of awarding those persons who work until full retirement age requirement.

Although average pensions in Serbia are low in relation to the cost of living, they are relatively high in relation to GDP and salaries from where they are funded. So, an average pension in Serbia amounts to 58% of the average salary, which is high in relative terms, in relation to the other countries of Central and Eastern Europe. Therefore, in order to bring expenditure for pensions in Serbia down to the average level of CEE countries (around 10% of GDP), it is necessary to continue with its restrictive indexation in the course of 2015 and 2016. On the other hand, the age requirement for retiring in Serbia (65 for men and 60 for women) is in average lower than in other European countries, given that a large number of persons retire based on the fulfillment of the number of working years required for retirement, without reaching the required age, so due to that fact, the real average age of the people retiring is significantly lower than the minimum age prescribed by the law. Thus, one half of women and three quarters of men are retired in Serbia before full retirement age, which is much higher figure than in the other European countries. That is a consequence of the fact that practically all countries in Europe have certain measures incorporated into their pension systems, which award retiring at the full retirement age, and that is not the case in Serbia. Also, the difference between the retirement age for men and women in Serbia is among the highest in Europe where most of the countries significantly decreased or eliminated this difference in the past decade.

Taking the above mentioned as a starting point, it can be concluded that in order to provide long-term sustainability of the pension system in Serbia, it is necessary to conduct a pension reform in Serbia in 2014, which would include the following measures:

- Continuation of pension indexation in relation to the GDP growth for the period of next three years, according to the wages indexation;
- Lifting up the minimum retirement age from 58 to 60 years of age;
- Diminishing the difference in retirement age for men and women, starting from the practice of almost all other European countries. Such difference (between men and women) could be diminished gradually - for example, by six months in each calendar year, so that until 2020 retirement border for women is lifted to 63 years. Although women put lots of effort in bringing up children and taking care of household, the average life expectancy of women is five years longer then of men, so based on that, the existing difference is unjustified. Besides, this reform would diminish, in the forthcoming years, an additional pressure on the pension system, which will happen due to the negative demographic trends;
- Introducing the actuarial fairness factor into the pension system would mean that the persons who retired before full retirement age would receive pensions decreased by 6% for each year below retirement age, and that would mean an incentive and award for those persons who opted to work until full retirement age. Thus the system would become actuarially fair and, at the same time, positive effects would show in terms of diminishing grey economy ("work on black") because now a great number of retirees, who retired before their retirement age, continue to work informally (unregistered) after retiring for a number of years more. In this way, savings of 0.1% of GDP per annum would be made in expenditures for pensions, and these savings would increase up to 0.4% of GDP with time.

- Restricting criteria for granting so-called discounted (reduced) years of service in such a way that this entitlement would be restricted only to such profiles that are exposed to a high risk at work (e.g. miners, firefighters policemen, and others), but should not be granted to the other people employed in such a type of institution if they work in administration or similar jobs (for example, it cannot be justified that an admin person working at the accounting department in Police or Army is entitled to the discounted years of service).

Estimated increase in the retirement age for women, the introduction of actuarial penalty for early retirement and the tightening of the criteria for the allocation of extra service credit, would provide savings in pension expenditure from 2016, with the effects increasing in the future.

Certain number of CEE countries introduced, in earlier stage of transition, so-called Second Pillar of Pension Insurance, i.e. mandatory private pension insurance based on the full capitalization principle. In order to economically justify introduction of the second pillar and, based on that, to provide reasonable amount of pensions in the future, it is necessary that the contribution for this form of insurance should be min. 10% of salaries. Given that cumulative social insurance contribution rate in Serbia is already high, its increase for further ten or more percentage points would have a negative impact on employment, economy growth and informal employment. Alternatively, redistribution of the existing income from contributions (14% - first pillar, 10% - second pillar) would result in an increase of the PIO Fund deficit and consolidated fiscal deficit by around 3% of GDP. Third option, meaning that all new employees participate in the second pension insurance pillar while current employees remain insured within the first pillar, would also result in an additional fiscal deficit within the first pillar and such deficit would grow with time. Apart from extremely negative fiscal effect, the introduction of the second pension insurance pillar under the conditions of global economic instability may also bring significant non-fiscal risks. So, due to the fall of securities market, the assets of pension funds in some CEE countries have significantly dropped (e.g. Hungary) and it resulted in disappearance of this pillar. Having in mind the above mentioned, it is estimated that introducing the second pension insurance pillar can be neither economically justified nor fiscally feasible in this moment in time, but the activity should be directed towards further parametric reform of the first pension insurance pillar with a purpose of strengthening its long-term sustainability.

Social Protection System Reform

In line with the Strategy for Development of Social Protection, the Law on Social Protection and the Law on Financial Support to the Families with Children, will be provided continuation of the improvement of the social protection system in terms of better targeting social protection and more efficient funding the program for financial social support and child allowance.

An increase of expenditures for social protection is planned in 2015, in the first place for the amount of material support of families ("MOP"), as the principal form of social assistance, regarding the fact that tax reforms and other measures of fiscal consolidation will hit poor population. Thus, the number of the social assistance recipients will increase and the amount of assistance per head, along with reform of criteria for granting as stance. So, the payments for targeted social assistance will be increased, conditioned by the financial status of the recipient.

The reform of the social protection system will be directed towards an increase of assistance for the most vulnerable population in the period of next three fiscal years and, at the same time, non-selective and expensive social protection programs will be revoked or altered. The reform of the social protection system will provide better directing of available funds for social payments and redistribution of the existing funds for social purposes since it cannot be expected in midterm period to have a significant increase of funds earmarking for social protection due to high budget deficit and public debt.

On the national and local level, better selection and targeting of social policy will be provided in order to secure budget funds for families and individuals who need the assistance the most. Social policy will be directed towards the programs for protection of the poorest population with the purpose to provide sustainability of payments for social assistance. For that purpose, social cards will be established so that social assistance is provided for the beneficiaries who do need it.

Improvement of the social protection system means better accessibility and better social protection quality and also diminishing administrative barriers for obtaining social assistance according to the material status of beneficiary. However, it is necessary to increase financial sustainability of the social protection system. In those terms, it is planned intensified assets control of users of beneficiaries of child and veteran allowances, being the most expensive social protection programs.

Reforms of the Enterprises in the Process of Restructuring

Ministry of Economy will prepare the Action Plan for putting on their feet the potentially prosperous companies and closing unsuccessful enterprises from the Agency for Privatization portfolio (615 enterprises employing around 100,000 workers), with a particular analytical review of the financial condition, assets and liabilities of the enterprises in restructuring (179 enterprises in the restructuring process employing 54,000 workers). At the same time, reliable financial reporting shoul be established, which suppose certain changes in the Law on Accounting and the Law on Audit, which will enable inforcement of the international standards in the accounting and audit.

After 12 years of transition in Serbia, the remaining enterprises in restructuring receive direct and indirect budget subsidies, which influence an increase of the total expenditures and fiscal deficit. According to the World Bank estimation, 750 million Euros was earmarked for the enterprises in restructuring in 2012 in the form of direct and indirect subsidies (all kinds of fiscal cost incurred on the basis of the cash transfers or uncollected and due public revenue).

Enterprises in the process of restructuring survived thanking to the fact that they were protected from forcible collection/account blockage and bankruptcy and in their up to now business they accumulated losses above the capital amount of RSD 75 billion. By amendment to the Law on Privatization, forcible collection is limited by date until June 30, 2014, which will force the enterprises in restructuring to complete their restructuring process within this deadline. Therefore, the new Law on

Privatization will be enacted and the Law on Bankruptcy and the Labor Law will be amended, which will regulate the procedures for restructuring and privatization of these enterprises, the bankruptcy procedure, and the funding of social programs for the working force surplus in these enterprises. New system solutions are necessary for the restructuring of 179 enterprises that have significant assets and number of employees, and on the other hand they generate the most losses and liabilities.

Out of 179 enterprises in the process of restructuring, in the third quarter of 2103, the restructuring procedure was completed in 27 enterprises through liquidation or bankruptcy - for those enterprises, there are no interested buyers and they are not active (holding companies), but they have some assets and a small number of employees. Other enterprises in restructuring will file bankruptcy too, if they do not succeed to sell their assets/capital or some other sustainable business solution is not found for them until the deadline for completion of restructuring elapses.

Other enterprises, 135 enterprises in rectructuring and 419 from the Agency of Privatization portfolio, which employ 36.000 workers, will be also privatized against the method which the new Law on Privatization will establish. Attention will be paid to the schedule of initiation of bankruptcy procedure for those enterprises for which buyers are not found, depending on administrative capacities and the cost of conducting the bankruptcy procedure and the cost of social programs. The decissions about the privatization method of the companies will be delivered by the Ministry of Economy, with special emphasize on the enterprises with strategic interest for the public interests.

The main objective of these reform activities is to have sound economy on sound system foundations, which will be able to generate employment growth leading to the real growth of salaries and living standard. In order to achieve this end goal of economic policy, it is necessary to establish an efficient and liquid market with regulated monopolies, where they are naturally needed. Sound companies will survive and will be strengthened through market competition; those companies, which employ work force, bring in innovations, and own a real product and the market. Along with that, it is necessary to disburden companies from tax and quasi-fiscal tributes, which represents a powerful stimulus for employment and company growth and for legally earned profit in carrying out production activities in the first place.

The Reform of Public Enterprises and Public Capital Companies

Competent ministries, within their mandate, on the national and local level, will prepare, by the end of 2013, analytical reviews of the financial condition, assets and liabilities of all public enterprises for the purpose of their restructuring and putting them on their feet.

Necessary reforms should be conducted, which will improve management and enhance efficiency of public enterprises and public capital companies:

- Introducing accountable corporative standards of management in all public enterprises. At the same time, efficiency in the control of these enterprises will be established, but independent management, also. All the payments to the empoyees will be based on the efficiency of the plan implementation and results obtained. With those measures, all the problems related to the bad corporative management, based on interference of the state and politics into the economy, social and labor policy funtions of those enterprises, will disappear;

- Defining criteria of efficiency for measuring business performance of public enterprises. The rise of efficiency of public enterprises involves reduction of direct and indirect subsidies and rising of prices to the economic level for the services of public enterprises. In parallel with the setting of efficiency criteria further liberalization will be necessary of the activities where public enterprises are operating, and which do not have the character of natural monopoly (electricity generation, railway transport, certain communal utilities), which would have a positive impact on the raising of efficiency in the economy, better quality of public services, greater financial discipline, and curbing of corruption.
- In order to improve business performance, the process of converting big state enterprises into shareholding companies will be completed, with appropriate regulation of their specific characteristics in carrying out activities of general interest under non-market conditions. Corporatization will simplify the legal frame and decrease business risks and cost, enable easier change of structure and forms of capital, and improve crediting conditions and thus attract private investments. This will give incentive to the market rules in doing business and will improve the public services quality long-term;
- Increase of efficiency and productivity of public enterprises based on better management, improved way of doing business, technical improvements, reduction of the number of employees, privatization of public enterprises, which can do business under conditions of competitiveness, liberalization of product and service prices of these enterprises and increase of products and service prices of public enterprises up to the level of justified cost will significantly contribute to the decrease of public spending and fiscal deficit throught reduction of direct and indirect state subsidies;
- Transparency of public enterprises activities will be provided through regular publication of annual/semiannual reports, such as cumulative business reports of public enterprises, financial reports, and reports on public procurements, received aid, subsidies, guarantees, financial risks, doing business with linked entities, etc;
- More efficient mechanisms will be established for the control over public enterprises. For that purpose, regulations, scope and methodology for drafting business plans and deadlines will be defined. The rules will be established and key indicators defined for evaluation of successfulness of public enterprises, as well as for evaluation of performance of public enterprise management at least once a year;
- Debt restructuring of public enterprises and gradual abandonment of practice of issuing guarantees for the of public enterprises` borrowings.

Subsidies System Reform

A transparent planning system and system of granting and control of spending all budgetary subsidies will be established, with significant changes in the structure and mechanisms of granting subsidies. All programs receiving subsidies will be incorporated into the budget for the following year. The competent ministry will report annually to the Government how subsidies were distributed and on effects of granted subsidies.

Given that non-restructured and non-privatized enterprises, which are under state control, have a negative impact on economic performance and financial discipline, giving an incentive to corruption, it is necessary to accelerate restructuring and privatization of those enterprises, which will contribute to the decrease of the total expenditures for subsidies. The reform of state and public enterprises will be followed by gradual diminishing and phasing out of subsidies.

Creating a healthy and sustainable economy based on the growth and competitiveness requires modification of the existing model of subsidizing the economy. Operations of public enterprises in restructuring, whose status can be resolved by the deadline established by the Law on Privatization, will be financed from the budget of the Republic of Serbia. In addition, the state will fund operations of public enterprises which can not operate positively in terms of competition, with the obligation to restructure.

On the local municipalities level reduced funding is planned, especialy in the public community enterprises, with improvement of their cost-effectiveness and and increase in the prices of services provided by those enterprises. In the case of local communal enterprises which have no natural monopoly, privatization is planned or to have public/private partnership.

The orientation is to compensate direct and indirect subsidies by the improvement of business environment through "guillotine of regulations", reduction of the number of days and the number of procedures for obtaining construction permits, ceding land, more flexible labor market, better protection of competition, and less tax and quasi-fiscal burden of the economy and population.

A change of subsidy policy in agriculture is envisaged in terms of giving incentives to the investments, which increase of productivity and competitiveness of agriculture and improvement of agricultural infrastructure.

Public Finance Management Reform

Within the system of public finance management of special significance are the amendments of the Budget System Law which enhance the system of control of the number of employees and wage bill in the public sector. In the next three year, in addition to restrictive indexation of wages and pensions, significant effects are expected from the enhancement of the system of control of wages and number of employees in the public sector on the basis of a single registry and centralized accounting of earnings of all employees in the public sector. For the implementation of these measures Amendments to the Budget System Law, Amendments to the Law on Civil Servants and Civil Servants Salaries, and other changes regulating employee benefits in the public sector (police, defense, judiciary, education , health care, etc.) will be required in the coming year.

In order to establish a Register of the employed, elected, appointed and engaged persons in the public sector, the Government has adopted, in August 2013, the

Regulation which prescribes the form and content of the forms on which public funds beneficiaries provided data that are entered in the Register, the way for filling the forms and method for their processing and delivery. On the basis of this Regulation, the Treasury has established, within the specified time, a unique Register of the employeed and engaged persons in the public sector, which represents a basis for starting the phased implementation of the centralized accounting of salaries of the persons employeed and engaged in the public sector in 2014. This will enable the monitoring of all expenditures for public sector employees such as wages, payment for overtime and night work, bonuses and all other costs, creating thus the conditions for the eliminating all fictitious and unnecessary expenses for employees in the public sector. Registry will be administered by the Treasury in electronic format with the obligation of all beneficiaries of public funds at all levels (institutions, organizations, regulatory bodies and agencies) to submit on a monthly basis data on the number of the persons employed or engaged on any ground and on their income.

Establishment of the central Registry of employees in the public sector is in the final stage. The Registry will include all direct and indirect beneficiaries of the Republic budget and local government budget, organization of mandatory social insurance, public agencies and other entities that are controlled by the state, and all public enterprises at national and local level. It is expected that the centralized calculation of personal income for employees in the Republic administration and public services will begin in 2014.

Based on data on the actual number of employees given in the Register, the analysis for the previous period will be made, and based on it the number of employees required in each area of the public sector will be determined and changes in the regulations governing the new employment and promotion will be made. The goal is to achieve significant budget savings in public administration and public services, and to increase the efficiency of public administration and public services. Therefore, the reform of the policy of salaries and other incomes in public sector will be done in 2014 through the introduction of standardized salary grades, the correction of coefficients and methods of promotion and reward of employees and the correction of methods of determining fees for membership in governing bodies, committees and the like, which will be one of the requirements for starting a centralized calculation of personal incomes in the Republic administration and public services. In addition, in order to determine the optimal number and structure of employees in the public sector the targeted rationalization aimed at increasing of cost efficiency and quality of public services will be implemented. The effects of these measures are expected at latest in 2015 and in subsequent years.

By the end of 2013 and during 2014 the comprehensive preparation of institutions will be conducted for the introduction of program budgeting, which is anticipated, according to the Law on the Budget System, for the budget year 2015. To this end, methodology for regulating the manner of creation and the content of the program budget for all budget users will be determined and, after that, the training and the inclusion of budget beneficiaries in the budget process will be intensified. In contrast to the linear and the existing program budget in pilot ministries, this methodology, among other things, will enable monitoring of programs, projects and program activities as well as the associated funding by sectors, corresponding to the division within the sector approach for the planning of EU assistance. In addition, the monitoring of the funds invested in the implementation of activities in the negotiation process with the EU, under chapter 35, will be provided. Also, program budgeting and the application of this methodology will make available information on how much is invested in the regions in Serbia.

The adopted amendments to the Budget System Law, in a part related to capital investment, will contribute to the further establishment of systematic approach to capital investments by defining the notion of capital project, and prescribing the adoption of bylaw which will more closely regulate the content and the way of capital project preparation. In addition, the obligation is prescribed for the budget users to submit, within the deadlines stipulated by the budget calendar, the proposals of capital projects to the Ministry of Finance, after their assessment. The procedure of assessing capital projects is regulated by an act of the Government. The expected effects of the above mentioned changes are: (1) more efficient, economical and effective implementation, that is improvement of cost efficiency of investments, (2) establishing the legal basis for the evaluation process of capital projects, that is cost-benefit and analysisof feasibility, which will contribute to establishing the real priorities, better coordination and transparency in the selection of capital projects, and (3) providing conditions for greater accountability and mechanisms for improvement of capital projects managing.

Responsibility of the budget beneficiaries for appropriate planning is also introduced, in line with the envisaged implementation schedule, the amount of expenditures for the funding of the participation of the Republic of Serbia in the implementation of the EU financial aid when the EU financial aid funds are given to the Republic of Serbia to manage them, in line with the international agreement between the Republic of Serbia and the EU, they are responsible for the appropriate planning of the expenditure amount which will be funded by the EU financial aid.

The Reform of Management of Local Public Finances

In order to enhance the fiscal accountability of local self-governments, the transfer system will be revised in order to give incentive to local self-governments to implement the planned restructuring of local public enterprises. This will provide a decrease of subsidies to communal enterprises and increase of the quality of their services. At the same time, local self-governments will be motivated to use their own fiscal capacity.

Priority activities and measures for improvement of local public finances are:

- Better control of expenditures on the local level and limiting growth of employment, salaries and subsidies in local self-governments, as well as a transfer of certain authorities from the Republic level onto the local self-governments in the area of transport infrastructure, education, and healthcare and social protection;
- Improvement of public policies on the local level and elevating service efficiency for services provided by the local self-governments through bigger investments in local public projects and growth of cost efficiency of investments;

- Accelerating the process of returning assets to the local self-governments;
- Improvement of business environment on the local level by removing administrative barriers, removal of unnecessary bureaucratic procedures, introduction of e-administration, and decrease of corruption;
- Legislative regulating the rules (criteria) for establishing the level of development of local self-governments, which represent the basis for transfers to the local self-government units;
- Linking the amount of transfer to the level of collection of authentic income of the local self-government units.

Tax System Reform

Growth of employment in Serbia in the forthcoming period is possible only after dynamic mobilization of economic activity given that the growth of investments and exports is the only mechanism for sustainable growth of economic activity in upcoming years. In connection to this, in the forthcoming period, the Ministry of Finance will commence activities on the tax system reforms in order to:

- Give incentive to the economic growth based on investments and exports, which will generate a dynamic growth of employment;
- Provide full horizontal equity in taxation, so that individuals with the same income and property will be equally taxed;
- Improve vertical equity in taxation through redistribution of tax obligations according to the income levels;
- Diminish risks related to the application of taxes by specifying certain provisions of tax regulations and by aligning the approach towards them in terms of their interpretation;
- Additionally harmonize tax regulations and practice with the rules prescribed by the EU directives, as well as with a good practice of the developed European countries;
- In the middle term, gradually decrease in tax burden of the inputs, especially labor imput, transfer of the base of tax policy from the labor taxes to other objects of taxation in a way that should be less balance neutral.

The tax system reform represents one of the most important system reforms in public finances and in the economy of a country. Due to this reason, it is necessary to start the reform on the basis of the previously carried out detailed analysis on the implications of possible scenarios of the reform; and due to that, the reform will be carried out in stages, starting as of 2015.

Since 2006, the volume and value of goods and services provided by the government has been continuously increased (dynamic growth of wages and pensions, increasing subsidies, etc..), while the main tax form, have been decreased on several occasions in this period (introduction of non-taxable part of income, lowering the tax rates on incomes from 14% to 12% and then from 12% to 10%, with an increasing rate of contributions for pension and disability insurance and growth in a tax-free part of the income, transfering of certain assets to the group taxable at the reduced VAT rate, etc..), causing thus the emergence of high- fiscal deficit of a structural nature. Therefore, the tax system reform can not be aimed at reducing thetotal tax burden, but it must be designed and implemented in the revenue-neutral manner. However, taking into account the new empirical studies and the experiences of other European countries, it can be concluded that it is possible to stimulate investments, exports and employment through the redistribution of tax burden between different types of macroeconomic tax bases. In this regard, the Ministry of Finance shall, during the first half in 2014, make a thorough analysis of the different modalities of tax reform, using the modern methods of economic analysis, with the aim of defining the concept of reform that would have the greatest positive effect on investments, exports and employment. If the results show that with such a reform one can achieve significant results in terms of encouraging investments, exports and employment, the proposal will be referred to a broad public debate with an aim to include both relevant expertise and the general public, in the design of such major reforms. Based on this, the final proposal on the fundamental tax reform will be developed, which will be referred to the National Assembly of the Republic of Serbia in the second half of the year. At the same time, the activities concerning the preparation of the tax administration and the taxpayers for the administration and enforcement of the new tax system will be intensified in the second half in 2014, so that the implementation of the new tax regime can start from January 2015. In 2015 and 2016, activities will be focused on the implementation of the new tax regime, and at the same time its effects will be monitored in order to timely response to the identified difficulties associated with its implementation.

When it comes to the further fine tuning of basic forms of tax, the Ministry of Finance will, starting from their own analyses and suggestions of the relevant social factors (trade unions, chambers of commerce, associations of employers, associations of foreign investors, and others), be working continuously on further improvements of the legal framework for the administration and implementation of the existing forms of taxation. Although a significant improvement in those terms was recorded in the previous period, fine tuning of the tax system represents a continuous process because modern business processes open up new issues related to the taxation. The objective of this segment of the tax reform will be diminishing uncertainty, risks, and costs related to doing business in Serbia.

Also, in the context of negotiations for the accession to the EU, further harmonization of the tax regulations with the existing and new directives of the EU will be carried out. No greater challenges are expected in view to that since those forms of tax that are highly harmonized on the EU level (in the first place VAT and excise) are harmonized to a great extent in Serbia with those rules as well. At the same time, starting from a good tax (anti-evasive) practice of the developed countries, further improvement of the national institutional framework will be carried out.

In 2014, a transfer to electronic, on-line, submission of tax return forms will be fully completed, as well as the introduction of a unique tax return form for the employed, and the introduction of one sole account for the payment of fiscal dues that are paid on income of employed persons. In such a way, the regulatory cost for the application of tax regulations will be significantly decreased. Parallel to this, the Ministry of Finance will intensify their activities on organizational, technical and HR strengthening of the Tax Office with an aim of further modernization and increase of efficiency of their work.

Within the improvement of the legislative framework of the existing tax forms the law on administrative fees for the use of public goods will be passed in 2014, integrating all charges paid for the use of natural resources, public goods of common interest and public goods in general use (public goods), which are set forth in 17 non-tax law. Many taxes were abolished last year as a part of the abolition of a number of para-fiscal levies (138). The new Law on Republic Administrative Fees would significantly improve the transparency of public revenue system, ensure the predictability of the cost of economy, and increase the revenues from these sources, through the division of responsibilities for the control and collection of fees for the use of public resources At the same time, the introduction of hidden taxes through prescribing fees that are not associated with the use of a public good would be prevented.

V. Matrix of Economic Policies and Structural Reforms in the Period 2014-2016

KEY AREAS	MAIN OBJECTIVES	MAIN MEASURES AND ACTIVITIES	EXPECTED EFFECTS	ASSESSMENT OF FISCAL IMPLICATIONS	COMPETENT INSTITUTIONS	PREPARATION PERIOD	IMPLEMENTATION PERIOD
ECONOMIC POLICIES IN THE PERIOD 2014-2016							
I. GENERAL MACROECONOMIC FRAMEWORK AND MAIN OBJECTIVES OF ECONOMIC POLICY							
		Implementation of systemic reforms through the enactment of necessary systemic laws and implementation of the enacted laws.					
	Acceleration of the EU integration process.	Administrative capacity building and institutional stability.	Expedited negotiation of SAA chapters		Government of the Republic of Serbia and ministries within their respective fields of competence	2013	2014-2016
		Compliance with the Copenhagen criteria					
		Coordination of fiscal and monetary policies.					
	Macroeconomic stability.	Reduction of macroeconomic imbalances - inflation, fiscal deficit, current account deficit. Stabilisation of public debt.	Stability of public finance, economic growth, low inflation and boosted competitiveness		Government of the Republic of Serbia, ministries within their respective fields of competence and NBS	2013	2014-2016
Economic policy		Fiscal consolidation, improvement of the business environment and promotion of development through more efficient use of EU funds.					
	Promotion of economic growth based on investment and exports	Promotion of those industries that contribute to GDP growth.					

	and growth of employment and standard of living.	Higher investment in the generation of new employment in the private sector. Reform of the legal framework for the labour market, elimination of obstacles to employment, reduction of labour costs and increase in employment.				2013	2014-2016
Monetary policy	Price stability	Use of the interest rate applicable to 1-week reverse repo operations as the main monetary policy instrument			NBS		
III. FISCAL FRAMEWORK							
		Measures on the revenue side Eradication of the informal economy. Increased special VAT rate. Additional revenues from implementation of the Law on Reduction of Net Revenues in the Public Sector.	Reduction of fiscal deficit from 5.6% of GDP in 2013 to 2.3% of GDP in 2016 through fiscal consolidation measures.				
Fiscal policy	Fiscal consolidation	***Measures on the expenditure side*** Restrictive indexation of public sector salaries and pensions. Control and restriction of performance-related bonuses for public sector employees. Reduction of expenses for purchased goods and services through rationalised and more efficient control of procurements. Reduction of interest expenses for public debt refinancing by obtaining access to cheaper sources. Increased social welfare expenses due to the increasing number of welfare recipients and the increased amounts of financial assistance provided to families.	Reduction of general government deficit from 5.6% of GDP in 2013 to 2.3% of GDP in 2016 through fiscal consolidation measures.		Government of the Republic of Serbia and ministries within their respective fields of competence	2013	2014-2016
IV. STRUCTURAL REFORMS IN THE PERIOD 2014-2016							

Labour legislation reform	Higher employment rate	Amendment of the Labour Law	Increased labour market flexibility		Ministry of Labour, Employment and Social Policy	2013	2014-2016
Reform of the building permit issuing system	Improved business environment	Enactment of a new Planning and Construction Law	Easier, faster and cheaper issuing of building permits		Ministry of Construction and Urban Planning	2013	2014-2016
Public administration reform	Creation of a rational, accountable and sustainable public administration, professionally qualified and efficient in the execution of its duties.	Adoption of a new Public Administration Reform Strategy with an action plan.			Ministry of Justice and Public Administration and Ministry of Regional Development and Local Self-government		2014-2016
Pension system reform	Ensuring long-term sustainability of the pension system	Amendment of the Law on Pension and Disability Insurance in 2014 and its enactment by the end of 2014 (increasing the retirement age for women, introduction of actuarial penalties for early retirement, more stringent criteria for reduced years of service).		Introduction of actuarial fairness would achieve savings of 0.1% of GDP per annum on pension expenditures within two years, ultimately increasing up to 0.4% of GDP.	Ministry of Labour, Employment and Social Policy	2014	2014-2016
		Preparation of analytical reviews of financial situation, assets and liabilities of companies by the end of 2013.					
Reform of enterprises in restructuring	Building a healthy economy on sound systemic foundations to generate employment growth resulting in increased salaries and standard of living in real terms.	Enactment of a new Privatisation Law by the end of 2013.	Reliable financial reporting		Ministry of economy	2013	2014
		Completion of restructuring and privatisation of enterprises in the portfolio of the Privatisation Agency in 2014.					
		Preparation of analytical reviews of financial situation, assets and liabilities of companies .					

Reform of public enterprises	Establishment of an efficient sector of public enterprises.	Completion of restructuring of enterprises in 2014.	Increased efficiency of the economy, improved quality of public services, better financial discipline and lower corruption.		Ministry of economy	2013	2014
Reform of bankruptcy proceedings		Amendment of the Law on Bankruptcy			Ministry of economy	2013	2014
		Establishment of a central register of public sector employees by the end of 2013.					
Reform of public finance management	Increased efficiency of public administration and public services and significant budget savings.	Introduction of centralised calculation of salaries for public sector employees in 2014.	Improvement of the public sector employment and salary control system.		Ministry of Finance	2013	2014
		Introduction of standardised salary bands, adjustment of coefficients and employee promotion and rewarding methods in 2014.					
		Comprehensive preparation of institutions for the introduction of programmatic budgeting in the course of 2014.					
		Analysis of possible tax reform scenarios during 2014 and selection of a concept to be adopted by the end of 2014					

Tax system reform	Full horizontal equity in taxation	Preparation of the tax administration and taxpayers for the implementation of a new taxation regime in the second half of 2014			Ministry of Finance, Tax Administration	2013	2014-2016
	Additional harmonisation of tax regulations and practice with the rules set out in EU Directives	If tax reform is seen as justified, starting from 1 January 2015 a new taxation regime will be implemented and its effects will be monitored in 2015 and in subsequent years.					
	Gradual reduction of tax burden on inputs	Enactment of the Law on Fees for the Use of Public Resources in 2014					

Annex: Matrix of Success in the Implementation of Reforms under PEP 2013-2015

KEY MEASURES AND ACTIVITIES ENVISAGED BY PEP 2013-2015	ADOPTED (YES/NO)	DATE	COMMENTS
ECONOMIC POLICIES IN THE PERIOD 2013-2015			
1. Macroeconomic policy			
Implementation of systemic reforms through the enactment of new systemic laws and enforcement of the existing ones Compliance with SAA commitments Compliance with the Copenhagen criteria for EU membership	Yes	2013 - continual	The SAA between the Republic of Serbia and the EU came into force on 1 September 2013. Regular political and economic dialogue between the Republic of Serbia and the EU has continued through the structures of the SAA/Interim Agreement and as part of Enhanced Permanent Dialogue. The Committee on Implementation of the Interim Agreement meets on a regular basis, while the country participates in multilateral economic dialogue with the European Commission in order to prepare for participation in the common economic and monetary policy of the EU. The Republic of Serbia has adopted the National Programme for the Adoption of the Acquis Communitaire (NPAA) for the period 2013-2016. The European Commission, in consultation with the Government of the Republic of Serbia, is currently working on the Country Strategy Paper – a programme document which promotes a sectoral approach in allocation of financial assistance and which will define the objectives, results and indicators for every sector the EC intends to fund in the period 2014-2020, within the framework of the new Instrument of Pre-accession Assistance (IPA II). To that end, in 2013 the Serbian European Integration Office (SEIO) prepared the document titled "National Priorities for International Assistance in the Period 2014-2017 with Projections until 2020" (Needs Assessment Document - NAD), which the Government of the Republic of Serbia adopted on 8 November 2013. On the basis of the draft Country Strategy Paper, the NPAA and the NAD, in late 2013 SEIO launched a new programming cycle for applications for IPA II funds. As regards management of IPA funds, it is expected that in 2014 the European Commission will transfer management powers for EU funds to the Republic of Serbia, in accordance with the submitted accreditation package. The Republic of Serbia participates in a number of EU Programmes: the Seventh Framework Programme for Research and Technological Development, the PROGRESS Programme, the Competitiveness and Innovation Framework Programme, the Culture Programme, the Europe for Citizens, the Customs Programme and the Fiscalis Programme. Negotiations on Serbia's participation in successor programmes to the current EU Programmes in the period 2014-2020 are underway.
Obtaining the date for accession negotiations in 2013	Yes	2014	The European Council has confirmed the decision of the EU Council of Ministers to open the negotiations with Serbia on 21 January 2014.
Expedited negotiation of SAA chapters	Yes	2013 - continual	The Explanatory Screening Process began in September 2013 in Brussels. The Serbian European Integration Office has began organising seminars on each of the chapters, to familiarise civil servants with EU policies and brief them on the negotiation.
Coordination of fiscal and monetary policies Reduction of macroeconomic imbalances – inflation, fiscal deficit and debt, current account deficit	Ongoing	Continual	A Data and Information Exchange Agreement is scheduled to be signed between the NBS and the Ministry of Finance, to improve the coordination of monetary and fiscal policies. The Government of the Republic of Serbia has adopted the Fiscal Strategy for 2014 with Projections for 2015 and 2016, as well as the Pre-accession Economic Programme for 2014. The Fiscal Strategy defines a framework for fiscal consolidation.
Key structural measures on the revenue side:			
Competitive and efficient tax system Predictable tax policy Harmonisation of indirect taxation policy with EU rules Simplification of tax process and procedures Modernisation and improved efficiency of tax administration Absolute fiscal discipline	Ongoing	2013 - 2015	With the aim of improving the tax policy, tax reform has been set afoot by the enactment of the following tax laws: Law amending the Law on Personal Income Tax, Law amending the Law on Value Added Tax, Law amending the Law on Corporate Income Tax and Law amending the Law on Tax Procedure and Tax Administration. Full introduction of a system of e-filing of tax returns, as well as a system for integrated collection of withholding taxes, is underway. These are expected to significantly cut regulatory expenses (completion is scheduled for 2014).

Key structural measures on the expenditure side:			
Pacing the growth of public sector salaries and pensions according to the available budget funds	Yes	2013 - 2016	The planned and achieved indexation in 2013 was 2% in April and 0.5% in October, while in 2014 and 2015 indexation will be carried out in accordance with fiscal rules. The fiscal consolidation programme included in the PEP for 2014 provides for limited indexation of salaries and pensions in the period 2014-2016 (in April 2014, 2015 and 2016 by 0.5%, in October 2014 by 1% and in October 2015 and 2016 by 0.5%).
Harmonization of salary calculation rules across the public sector	No	2013/2014	A register of all public sector employees has been established towards the end of 2013. Preparations are underway for the introduction of unified salary bands. Most of this work is expected to be completed in 2014.
More stringent conditions for exercising the rights afforded by pension insurance	No	2014 - 2016	Amendments to the Law on Pension and Disability Insurance would, among other things, reduce the difference in the minimum retirement age for men and women, introduce the factor of actuarial fairness in the pension system and tightening the criteria for reduced years of service.
2. Specific economic policies			
Sanctioning of all forms of abuse of monopoly or dominant position and all other types of distortion of competition	Ongoing	2013 - continual	In the course of 2013, the Competition Protection Commission imposed three administrative measures against monopolistic behaviour in the market: twice against the companies Imlek and Mlekara Subotica, against the City Graveyard of Kragujevac and against the Belgrade-based company Frikom.
Assistance to pregnant women and nursing mothers	Yes	2013 - continual	Starting from 2014, women on pregnancy leave will receive an allowance corresponding to 100% of their salary.
VAT refunds on purchased baby items for the less affluent population categories	Yes	2013	VAT refunds for purchased baby items were introduced in 2013.
Employment incentives Social inclusion of persons who face difficulties in accessing employment, in particular the vulnerable categories of the unemployed Generation of new employment through improvements in the institutional and business environments Support for the development of social entrepreneurship Improved efficiency of social services	Ongoing	2013/2014	The new Labour Law is expected to contribute to flexibility of the labour market, thus facilitating new employment. Draft versions of the Law amending the Law on Professional Rehabilitation and Employment of Persons with Disabilities and the Law on Social Entrepreneurship and Employment in Social Enterprises have also been prepared and this is expected to greatly improve the status of vulnerable groups in the labour market. A budget fund is also envisaged to be set up for this purpose. Funding under projects implemented by the EU Delegation in Belgrade will be used for networking of non-governmental organisation with their EU counterparts, which will bring about to financial sustainability of NGOs and allow them to learn from good practice examples in the EU.
3. Sector-level economic policies			
Attraction of foreign investment in export-oriented industries Export support for the metal, automotive, electronics, food, pharmaceutical and military industries Completion of reconstruction of large industrial systems More efficient bankruptcy proceedings for those industrial companies that face bleak prospects	Yes	2014	Three types of systemic measures will be implemented in 2014, relating to attraction of foreign investment, assistance to state-owned enterprises, more affordable loans and regulatory reform. The Law amending the Law on Bankruptcy, the preparation of which is currently underway, as well as the Law amending the Labour Law, will facilitate the restructuring of public and socially-owned enterprises, thus significantly improving the business environment. The transition fund, which will be formed in 2014, will facilitate the transformation of these enterprises. The amendments made to the Privatisation Law limited the validity of the institute of forcible collection to 30 June 2014, which meant enterprises had to complete their restructuring by that date. The new Privatisation Law and amendments to the Law on Bankruptcy and the Labour Law will regulate the methods and procedures for restructuring and privatisation of these enterprises, bankruptcy proceedings and funding of social programmes for the redundant workers in those enterprises.

Completion of the highway through Serbia (Corridor 10)	Ongoing	2013 - 2016	On Corridor 10, 33.2 kilometres of highway and 13.7 kilometres of parallel roads have been opened for traffic. In addition, the first 2.4 kilometres of the highway on Corridor 10 towards Bulgaria have been paved. The 22.3 km long Y section (from Kelebija to the Subotica-South junction) is currently under construction, while works on the Dobanovci – Ostruznica section are underway. Construction bids are currently examined for the Petlovo Brdo junction and the Orlovaca junction.
Construction of a highway connecting Belgrade and western Serbia (Corridor 11) and a highway connecting Pojate and Preljina	Ongoing	2014 - continual	Towards the end of 2013, works will commence on two more sections of Corridor 11, Obrenovac – Ub and Lajkovac - Ljig, for which the main contractor has been selected. Also, the process of contractor selection for concession construction of the highway from Surcin to Obrenovac and from Preljina to Pozega is currently underway. The preliminary qualification stage has been completed and two companies out of the four that applied have been invited to submit their financial bids. In addition, documentation for continued construction of Corridor 11 from Pozega to the Mt. Zlatibor and Visegrad and of the section between Pozega and Boljari is currently under preparation.
Connecting the city of Kragujevac with Corridor 10 and the cities of Zajecar and Bor with Corridor 10 Connecting the towns of Loznica and Sabac with Corridor 10 and with the city of Novi Sad through the town of Ruma and a tunnel under the Mt. Fruska Gora Other infrastructural projects relevant for regional development	No	2015	/
Construction of a modern optical infrastructure State-of-the-art electronic communications and broadband Internet access	Ongoing	2013/2014	Public debate on the Draft Strategy for the Development of Broadband Networks and Services by 2016 was ended towards the end of 2013. The Ministry of Foreign and Internal Trade and Telecommunications is currently preparing an Action Plan to enable the implementation of this Strategy. Acting on proposal of the Ministry of Foreign and Internal Trade and Telecommunications, the Government adopted the Action Plan (2013-2014) for Implementation of the Strategy for the Development of Electronic Communications in Serbia in 2010-2020.
Improvement of primary and secondary education	Yes	Continual	The National Assembly enacted the Law on Secondary Education and the Law amending the Law on Basic Elements of the Education System, which provide for higher inclusion of children in the education system and make education more accessible to certain categories of the population. The Law also provides for career guidance and advancement in the education process, as well as a number of new features concerning better motivation of pupils, development of tolerance between pupils and better care of children's health and safety. The Law on Secondary Education adjusts the school curricula to the needs of higher education institutions and provides for a clear classification of secondary educational profiles, thereby facilitating enrolment to universities and advanced secondary schools.
Promotion of higher academic achievement	Ongoing	Continual	The National Assembly enacted the Law amending the Law on Higher Education in 2013, in compliance with the Bologna Declaration, with the aim of improving the standard of higher education institutions, introducing a three-level schooling system, increasing mobility and providing for higher involvement of students in the education process.
Increased investment in the development of educational infrastructure, within the available means in Serbia	Ongoing	Continual	Priorities for funding have been identified on the basis of the Amended Programme for Allocation of Investment Proceeds at the Ministry of Education, Science and Technological Development in 2013. Implementation of projects covered by the Programme has continued in compliance with the schedule according to which the documentation for completed public procurement procedures is to be submitted and in compliance with the timeframe for implementation of the signed work contracts or contracts for the purchase and supply of goods, as the case may be.
Establishment of public-private partnerships to expedite growth and apply innovations	Yes	2013	In 2013, the National Assembly enacted the Law amending the Law on Innovation Activities, which provides for allocation of budget funds for innovation activities. Regulations on the Manner of Implementation of Innovation Programmes in 2013 have been adopted in accordance with the Law.

STRUCTURAL REFORMS IN THE PERIOD 2013-2015			
Real sector reforms			
Reduction of administrative barriers and cutting and simplification of red tape at national and local levels, coupled with streamlining the number of institutions to which applications must be made and introduction of a "one-stop-shop" system for investors	Ongoing	2014 - 2016	To reinforce fiscal accountability in the period 2014-2016, measures will be taken to improve the business environment at national and local levels through elimination of administrative barriers, cutting unnecessary red tape, introduction of e-government and less corruption.
Lower corruption and crime	Ongoing	2013	July of 2013 saw the adoption of the National Anti-corruption Strategy of the Republic of Serbia for the Period 2013-2018. In August 2013, the country adopted the Action Plan on Implementation of the National Anti-corruption Strategy of the Republic of Serbia for the Period 2013-2018. A law on the protection of whistleblowers, which aims to reduce corruption and protect public interest, is expected to be enacted soon.
Simplification of tax payment	Yes	2013	In December 2013, the National Assembly enacted the Law amending the Law on Tax Procedure and Tax Administration which provides for a single tax return instead of 11 separate tax returns, as was the case previously, which will be filed only electronically before every disbursement of salaries, benefits and other income subject to withholding taxes.
Faster and more affordable issuing of building permits	No	2013/2014	A new Planning and Construction Law will be enacted to enable easier and cheaper obtaining of building permits.
Establishment of financial discipline through the enactment of a law that would set time limits for payment of liabilities in commercial transactions and efficient enforcement of bankruptcy legislation	Yes	2013 - continual	The recently enacted Law on Time Limits for Payment of Liabilities in Commercial Transactions sets time limits for the payment of liabilities in commercial transactions between the public sector and economic operators, to prevent defaults.
Regulation of property rights that are essential for efficient functioning of a market economy	Ongoing	2013 - continual	In October 2013 the National Assembly enacted the Law amending the Law on Public Property in order to extend the deadline by which public enterprises, stock companies and their subsidiaries must apply for registration of their title to state-owned properties which they beneficially hold.
Reform and modernisation of inspectorates according to EU standards	No	Continual	In parallel with labour legislation reform, more intensive efforts will be made to improve the efficiency of inspection services (in particular the Labour Inspectorate), to strengthen the supervision of compliance with the new, flexible norms of labour legislation.
Enactment of a law on fees charged for the use of public resources	No	2014	A Law on Fees for the Use of Public Resources will be enacted in 2014 which will provide for an integration of all fees payable for the use of natural resources, resources of common interest and resources in common use.
Shortening and simplification of procedures for the issuing of permits and legalisation of properties and communities	Ongoing	2013/2014	One of the prioritised activities aimed at improving the business environment in Serbia is simplification and shortening of the building permit issuing procedure. The aim is to enable easier and cheaper obtaining of building permits, which will require the enactment of a new Law on Planning and Construction.
Adoption of a national land management programme	No	2014 – 2016	The Programme will propose measures for amalgamation of fragmented plots of arable land.
Adoption of annual employment action plans	Yes	Continual	The main instrument of active employment policy is the National Employment Action Plan, which is passed every year in accordance with the Law on Employment and Unemployment Insurance. The National Employment Action Plan defines the objectives and priorities of employment policies and provides for programmes and measures to achieve them.

Promotion of professional development of employed persons through the development of a career guidance and counselling system	Ongoing	Continual	Development of a career guidance and counselling system is envisaged by the National Employment Strategy for the Period 2011-2020, as well as the Strategy of Career Guidance and Counselling in the Republic of Serbia.
Professional rehabilitation measures	Ongoing	Continual	In accordance with the Law on Professional Rehabilitation and Employment of Persons with Disabilities.
Development of the National Qualifications Framework	No	2014 - 2016	A precondition for the adoption of a new occupational classification is the adoption of the National Qualifications Framework, a document which would define what a student is able to do after graduating.
Development of the National Occupational Classification System	No	2014 - 2016	Development of the National Occupational Classification System and harmonisation of the occupational standards with the standard international occupational classification should facilitate communication with other countries and data exchange in the fields of labour and employment and migrations.
Improvement of labour relations and employment legislation	No	2014	Adoption of amendments to the Labour Law to increase labour market flexibility in Serbia and simplify the procedures involved in hiring and terminating employees. To this end, the amendments will address the systemic defects of the labour market and introduce modern worker protection mechanisms and employment incentives, while at the same time reducing the costs incurred by employers in case of redundancies.
Affirmation of online sales and services	Yes	2013	The enacted Law amending the Law on Electronic Commerce should afford legal protection in electronic commerce by empowering market inspectors to ban the provision of services in case of violation of the law. The Law will also apply to all those who operate in the Republic of Serbia, but do not have a registered office in the country.
Support to the growth of agricultural output, productivity, competitiveness and exports and promotion of investments in agriculture	Yes	2013 - continual	The Law on Incentives in Agriculture and Rural Development has been enacted, providing for the types of incentives, the manner of using those incentives, the formation of a Register of Incentives in Agriculture and Rural Development and the eligibility requirements for agricultural and rural development incentives.
Expedited restructuring of the agricultural sector in line with EU standards and increased investment in the development of agricultural infrastructure	Yes	2013 - continual	The agriculture budget for 2014 envisages higher investment and lower subsidies in agriculture, to prepare Serbian farmers for EU competition. Projects to initiate the works funded by UAE loans have been prepared.
Creation of an effective advisory service and a shift in farmers' behaviour	Yes	2013 - continual	The Ministry of Agriculture, Forestry and Water Management and the Serbian Agricultural Market Information System have set up a commodity exchange web site for Serbian agricultural produce and producers (AGROPONUDA).