6. Fiscal Trends and Policy

In Q2, the strong growth of tax and non-tax revenue continued, so the collection of total public revenue was significantly higher than planned, while public spending recorded a moderate decline, mostly within the planned scope, and a similar dynamic continued in July as well. In the period January-July 2017, the consolidated fiscal surplus was 73.5 billion dinars (2.9% of GDP). Growth of tax revenue is still widespread since all forms of tax revenue are growing, except for the excise tax, and the biggest impact on the growth of total revenue came from higher collection of tax on profit, as well as on social contributions and personal income. Non-tax revenue continued its growth, even though it was planned to reduce it by a quarter compared to the previous year. Total public spending was as planned, but capital spending in the first seven months of 2017 recorded a year-on-year decline of 18.4% and was only 2.2% of GDP, which was by around 7 billion dinars less than planned. Poor realisation of capital spending is considered negative from the perspective of stimulating economic growth. Fiscal result of the first seven months of 2017 was better by around 80 billion dinars compared to the plan, thanks to the three groups of factors – improved trade ratio and decreased cost of capital on the international market, which affected the increase of profitability of the economy. Second, increased collection of non-tax revenue, and finally, lower realisation of capital spending. If the trends from the previous part of the year continue, we could have a fiscal surplus of around 0.5% of GDP in 2017. Having a fiscal surplus in the period when the economy is growing at a rate that is significantly lower than expected, is considered unfavourable. The recommendation is to significantly increase capital spending in the coming period and thus decrease the restrictiveness of fiscal policy, so that the fiscal deficit can stabilise at a level of 0.5-1% of GDP. Public debt at the end of 2017 was 67.8% of GDP, which is by around 6.6% of GDP less than at the end of 2016, primarily because of the real appreciation of the dinar against the dollar and euro, as well as because of the positive current fiscal trends.

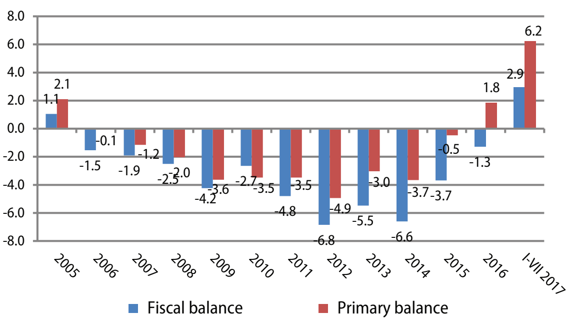
Fiscal Tendencies and Macroeconomic Implications

In the first seven months of 2017, a consolidated surplus of 73.5 billion dinars was realised (2.9% of GDP)

In Q2, strong real growth of public revenues continued and a moderate growth of public spending, compared both to the previous quarter and to the same period of the previous year. Growth of almost all revenue categories (except excise tax) continued in July as well, while public spending continued its decline, so the consolidated fiscal surplus in the first seven months of 2017 was 73.5 billion dinars (around 2.9% of the seven-month GDP). If we exclude revenue from interests, we get a primary surplus in this period of around 155 billion dinars (around 6.2% of GDP). Having a fiscal surplus in the period when the economy is growing at a rate that is significantly lower than expected, is considered unfavourable. The recommendation is to significantly increase capital spending in the coming period and thus decrease the restrictiveness of fiscal policy.

Strong growth of tax revenue continued

Graph T6-1. Serbia: Consolidated Fiscal Balance and Primary Balance (% of GDP)



Source: *QM* calculations

A significant real year-on-year increase of tax revenue (by 6%) was realised in Q2 2017, which is a continued trend from the previous quarters. Seasonally adjusted tax revenue increased considerably in real terms and compared to the previous quarter (by 2.4%).

All types of revenue are growing, except from excise tax

The growth of tax revenue was widespread, since the real increase was recorded in almost all types of tax revenue, except in excise tax.

Observed in real terms, the biggest year-on-year growth in Q2 was recorded in revenue from company profit tax (51.9%), which is

Especially strong growth was realised from profit tax, while tax on labour had quite an increase as well

the result of a strong growth in profitability of the economy in 2016, which in turn was the result of improved trade ratio (decreased energy costs) and decreased cost of financing on international financial market. A big impact on the growth of total tax revenue came from the strong increase in revenue from social contributions, which were higher in Q2 2017 in real terms by 5.1% compared to Q2 2016. The strong real growth of revenue from social contributions and profit tax in this period was the result of a moderate increase in wages and employment, and probably actions combatting informal employment. In Q2, there was a decelerated growth of revenue from VAT, since this type of revenue was higher by only 0.3% in this quarter compared to the same period of the previous year. After a mild decline in Q1, non-tax revenue in Q2 had a real year-on-year growth again (by 3.1%), which indicates a continued policy of aggressive collection of dividends from public enterprises.

In July 2017, there was a mild real year-on-year decline in tax revenue (by 0.6%) due to a considerable decline in revenue from excise tax (by 15.5%), while in other tax categories the dynamic of the previous months continued, and non-tax revenue recorded a strong increase (30.1%). Therefore, tax revenue in the first seven months of 2017 was higher in real terms by 5% compared to the same period in 2016, primarily because of the strong relative growth of revenue from profit tax (45.9%), as well as a considerable relative and absolute growth of revenue from social contributions and personal income tax (by 4.5% and 5.1%, respectively), while revenue from VAT recorded a mild real decline (by 1.6%), primarily due to a significant decline in revenue from excise tax on cigarettes, which could indicate a renewed rise in grey economy when it comes to the trade of these excise products.

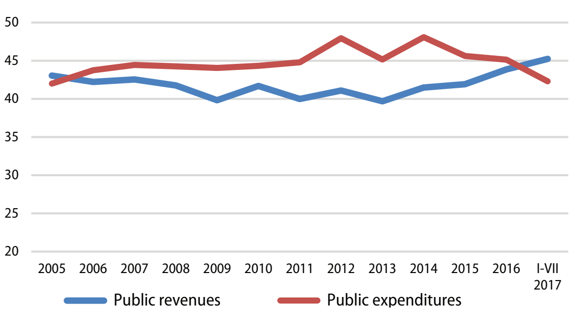
Therefore, it is estimated that the significant growth of tax revenue realised in the period January-July 2017 is the result of the increase in profitability of the economy (brought about by the improved trade ratio and favourable conditions of financing), and moderate growth of formal employment and wages. The relatively slow real growth of revenue from VAT is consistent with the data on low growth of economic activity in the first seven months of 2017.

Non-tax revenue is also growing significantly, even though the plan called for its reduction by a quarter

Non-tax revenue in the period January-July 2017 recorded a significant year-on-year real growth (by 5.2%), even though it was planned that non-tax revenue in 2017 should be reduced by almost a quarter compared to 2016. This was affected by the continued policy of aggressive collection of dividends from public enterprises in 2017, which had negative effects on investments and long-term business performance of these enterprises, as well as by the collection of nearly 9 billion dinars in dividends from NBS.

Public spending continued a mild decline, primarily due to reduced spending on wages, pensions and interest

Graph T6-2. Serbia: Consolidated Public Revenue and Public Spending (% of GDP)[1]



Source: *QM* calculations based on MF data

In Q2 2017, public spending continued its mild real decline compared to the same period of the previous year (by 1.7%), while it nearly stagnated in the previous quarter (-0.2%). The decrease of total public spending in Q2 was the result of reduced spending on interests (due to unbalanced payment dynamic), and continued mild decline of revenue on wages and pensions, while spending of goods and services, subsidies and capital spending recorded a growth in Q2. There was a considerable real year-on-year decline in spending in July (by 4.4%), primarily due to the decline in capital spending and subsidies.

In the period January-July 2017, consolidated public spending was by 1.9% lower in real terms compared to the same period of the previous year. Year-on-year decline was recorded in all spending categories except in procurement of goods and services. The highest relative year-on-year decline in this period was recorded in capital spending (by almost one fifth), while a moderate decline

1 Public spending* is adjusted for once-off spending on subsidies and pensions in December 2014 and 2015.

was realised in spending on interests (by 4.2%), primarily due to more favourable conditions of borrowing, which were the result of general decrease in interest rates on the international financial market, as well as of the reduced country risk thanks to fiscal stabilisation. Low indexation of pensions and moderate indexation of wages in the public sector at the beginning of 2017, as well as the continued policy of employment freeze, have all led to continued year-on-year real decline of wages and pensions, which significantly contributed to the mild reduction of total spending in this period.

Capital spending from January to July 2017 was lower by one fifth compared to 2016

Even though capital spending planned for 2017 was supposed to be by around 6% higher than in the previous year, in the first seven months of 2017, it recorded a real year-on-year decline by 18.4% and was only 2.2% of the seven-month GDP. In absolute terms, capital spending in the first seven months of 2017 was by around 7 billion dinars lower than planned. Since the decrease in capital spending was recorded in summer months as well (e.g. in July 2017, it was lower in real terms by 54% compared to the same month of 2016), the poor realisation of capital spending cannot only be attributed to bad weather conditions at the beginning of the year, but is probably also the result of poor planning and inefficient implementation of infrastructure projects. As was stated several times in previous issues of QM, increase of capital spending to 4-5% of GDP, which would bring it to the average level of Central and Eastern Europe, would have positive effects on economic growth, not just in the period of its realisation, but also in the period of exploitation of finished infrastructure objects.

The fiscal result in January-July 2017 was by around 80 billion dinars better than planned...

Starting from the internal dynamic of public revenue and public spending in the previous years, it is estimated that the fiscal result realised in the first seven months of 2017 was better than planned by around 80 billion dinars, more than half of which (around 50 billion dinars) was thanks to the higher collection of taxes, about one third (around 30 billion dinars) was thanks to the higher collection of non-tax revenue, while public spending (except capital spending) was realised according to plan.

…because of the growth in profitability of the economy, more aggressive collection of non-tax revenue, and poor realisation of capital spending

The biggest contribution to the higher collection of taxes than planned was made by the strong increase in revenue from profit tax (the plan was surpassed by almost 25 billion dinars), and higher collection of taxes than planned was realised in all other types of revenues as well. It is our conclusion that the positive deviation of tax revenue from the plan can mostly be explained by three groups of factors - *i)* improved trade ratio and decrease in cost of capital on the international market, which affected the growth in profitability of the economy, *ii)* collection of a large amount of dividends (9 billion dinars) from NBS, and *iii)* poorer realisation of capital spending. The factors that influenced the growth in profitability of the economy are exogenous and probably temporary, while aggressive collection of non-tax revenue and poorer realisation of capital spending were also unfavourable mechanisms for reducing the deficit, because they had a negative effect on the overall level of investments in the country, on the performance of public enterprises, and on future economic growth.

Fiscal balance or a minor surplus could be realised in 2017

If the trends in the dynamic of public revenue and public spending realised in January-July 2017 continue for the rest of the year as well, and if the state does not again take on obligations without guarantees of public and state enterprises, the consolidated state sector could realise a surplus of around 0.5% of GDP (around 20 billion dinars) in 2017. Favourable fiscal trends lead to increased pressure and promises regarding the reduction of taxes and increase of spending (e.g. big increase of wages and pensions). Realisation of these ideas and promises would probably not have a considerable effect on the fiscal balance in the current year, but the effects of it would show in 2018 when they start being implemented.

For faster economic growth, fiscal deficit should be kept at a level of 0.5-1% of GDP...

Considerable reduction of fiscal deficit and stopping of the growth of public debt in the previous three years are estimated as positive from the perspective of securing long-term sustainability of public finances. However, realising considerable fiscal surplus, which was 2.9% of GDP in the first seven months of 2017 (and primary surplus was as high as 6.2% of GDP), in conditions of a very low GDP growth rate (see *Economic Activity*), indicates that the fiscal policy is too restrictive. Therefore, the fiscal policy in the coming period should be designed to ensure further decrease of public debt, and to stimulate economic growth. In the coming period, a consolidated fiscal deficit of 0.5% and 1% of GDP would ensure further decrease of public debt.

and therefore, capital spending should be increased by 1-1.5% of GDP

Since the state will probably realise fiscal balance or minor surplus in 2017, the fiscal room of 1-1.5% of GDP should be used primarily to significantly increase capital spending, while current spending on wages and pensions should increase at a rate that would not be higher than the nominal growth rate of GDP (3-5%). Possible higher growth of wages and pensions in the public sector would mean a reduction of fiscal room for increasing capital spending or deficit, which would in both cases have negative effects on the dynamic of future economic growth.

Public Debt Trend Analysis

Serbia's public debt at the end of July 2017 was 66.8% of GDP...

At the end of July 2017, Serbia's public debt was 23.8 billion euros (66.8% of GDP). When we include the debt without guarantees of local self-government units, it amounts to 67.8% of GDP, which is by around 1 billion euros less than at the end of 2016.

...and when we include the debt of local self-government units – 67.8% of GDP

In relative terms, the debt at the end of July 2017 was by around 6.6% of GDP lower than at the end of 2016, because there was no need for net borrowing in this period due to the realised fiscal surplus, as well as the mild growth of GDP. Observed by debt structure, there was a reduction in the direct debt in the period January-July (by around 750 million euros), as well as the indirect debt (by around 250 million euros).

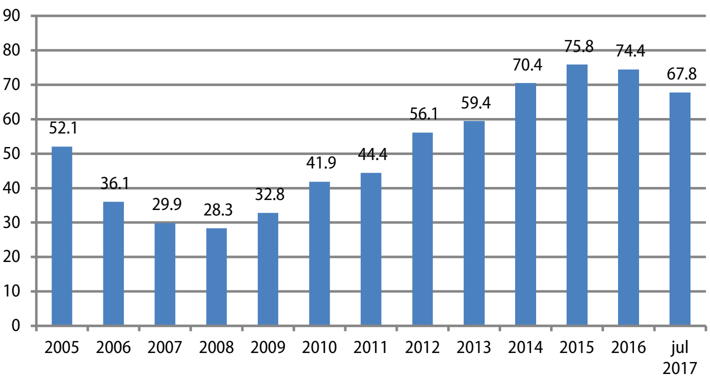
The reduction of debt was almost entirely the result of appreciation of dinar against the euro and dollar

The significant reduction of public debt in the period January-July was the result of the appreciation of the dinar exchange rate against the euro and dollar, as well as of the favourable fiscal trends, which is why there was no need for additional net borrowing in order to finance the fiscal deficit in the current period. The exchange rate of the dinar against the dollar in this period appreciated by around 15%, and considerable real appreciation was also realised against the euro (by around 5%). Considering the currency structure of Serbia's public debt, the appreciation of the dinar against the euro and dollar affected the nominal decrease of public debt by over a billion euros, which neutralised most of the negative effects of the changes in the exchange rate on the level of public debt at the end of 2016. Part of the reduction of the public debt in the period January-July could be considered temporary, since it is realistic to expect in the mid-term a mild real depreciation of the dinar against the euro, while the change in the exchange rate against the dollar could be even more significant due to the strong volatility of the euro exchange rate against the dollar.

Effective interest rate on Serbia's public debt is around 4.3%, which is estimated as negative

Appreciation of the dinar against the euro and dollar also affects the mild decline in the cost of interest, since around 80% of Serbia's public debt is denominated in foreign currency. In 2016, the implicit average interest rate, which is a ratio of cost of interest and the amount of public debt, was around 4.3% in Serbia, which is estimated as negative, compared to other comparable countries. Maturity of expensive loans from the previous period and their refinancing under currently more favourable conditions will affect the moderate decrease of implicit average interest rate in the coming period. Factors affecting Serbia's more favourable conditions of borrowing are the overall decrease of interest rates on the international capital market due to the expansionary monetary policy of ECB and the Fed, as well as the realised stabilisation of public finances. We should therefore use the current favourable conditions on the financial market and refinance some of the existing expensive loans, as well as to ensure funds for financing payments of matured debts in the coming period.

Graph T6-3. Serbia's Public Debt Trends (% of GDP)



Source: *QM* calculations

Good fiscal results realised in the first seven months of 2017 were the reason why there was no need for additional net borrowing by the state, while the strong appreciation of dinar affected the more considerable reduction in the absolute amount of the debt. Since the movement of the exchange rate in the coming period is unpredictable, in order to have a stabilisation and further reduction of the debt, it is necessary to stabilise the consolidated deficit at around 0.5-1% of GDP, and to make a significant progress in restructuring public enterprises (primarily EPS and Srbijagas), as well as privatising state-owned companies (petrochemical complex, RTB Bor, Galenika, Prva Petoletka, etc.), in order to avoid creating new losses and their spill-over to the consolidated state balance.

Annex

Annex 1. Serbia: Consolidated General Government Fiscal Operations, 2010-2017 (bn RSD)

	2010	2011	2012	2013	2014	2015	2016					2017			
							Q1	Q2	Q3	Q4	Q1-Q4	Q1	Q2	Q1-Q2	I-VII
I PUBLIC REVENUES	**1,278.4**	**1,362.6**	**1,472.1**	**1,538.1**	**1,620.8**	**1,694.8**	**414.7**	**460.8**	**476.9**	**490.3**	**1,842.7**	**449.9**	**503.8**	**953.7**	**1,133.7**
1. Current revenues	1,215.7	1,297.9	1,393.8	1,461.3	1,540.8	1687.6	413.3	458.8	472.5	488.7	1833.3	448.0	502.3	950.4	1130.1
Tax revenue	1,056.5	1,131.0	1,225.9	1,296.4	1,369.9	1463.6	353.2	405.0	405.3	422.2	1585.8	386.4	444.9	831.3	986.7
Personal income taxes	139.1	150.8	35.3	156.1	146.5	146.8	34.5	37.7	40.5	42.4	155.1	37.5	40.7	78.2	93.6
Corporate income taxes	32.6	37.8	54.8	60.7	72.7	62.7	13.3	31.1	18.1	17.8	80.4	18.9	49.0	67.9	76.6
VAT and retail sales tax	319.4	342.4	367.5	380.6	409.6	416.1	103.8	114.9	112.7	122.0	453.5	109.6	119.5	229.1	276.3
Excises	152.4	170.9	181.1	204.8	212.5	235.8	57.4	65.5	75.2	67.5	265.6	64.9	65.2	130.0	159.9
Custom duties	44.3	38.8	35.8	32.5	31.2	33.3	8.6	8.7	9.2	9.9	36.4	9.3	9.7	19.0	22.2
Social contributions	323.0	346.6	378.9	418.3	440.3	505.7	120.5	130.8	132.6	143.6	527.5	129.6	142.4	272.0	318.7
Other taxes	46.0	43.5	42.6	43.5	57.3	63.3	15.1	16.3	16.9	19.0	67.3	16.6	18.4	35.1	39.4
Non-tax revenue	159.2	36.9	37.9	34.9	170.9	224.0	60.1	53.8	67.1	66.5	247.5	61.6	57.5	119.1	143.5
II TOTAL EXPENDITURE	**-1,419.5**	**-1,526.1**	**-1,717.3**	**-1,750.2**	**-1,878.9**	**-1,844.0**	**-430.7**	**-462.9**	**-463.1**	**-543.0**	**-1,899.7**	**438.2**	**471.5**	**909.6**	**1,060.2**
1. Current expenditures	-1,224.8	-1,324.8	-1,479.9	-1,549.8	-1,628.0	-1696.6	-403.9	-419.5	-416.4	-478.2	-1,717.9	415.7	425.1	840.7	978.8
Wages and salaries	-308.1	-342.5	-374.7	-392.7	-388.6	-419.2	-99.8	-104.6	-103.7	-109.5	-417.7	102.5	108.2	210.7	245.1
Expenditure on goods and services	-202.5	-23.3	-235.7	-236.9	-256.8	-257.6	-57.5	-67.2	-68.4	-90.6	-283.6	60.5	72.8	133.2	157.6
Interest payment	-34.2	-44.8	-68.2	-94.5	-115.2	-129.9	-45.9	-32.0	-31.6	-22.0	-131.6	47.4	25.4	72.8	82.2
Subsidies	-77.9	-80.5	-111.5	-101.2	-117.0	-134.7	-18.0	-24.1	-20.4	-50.2	-112.7	18.9	26.6	45.5	51.1
Social transfers	-579.2	-609.0	-652.5	-687.6	-696.8	-710.0	-171.9	-176.3	-178.3	-190.3	-716.8	174.5	178.4	352.9	410.8
o/w: pensions5)	*-394.0*	*-422.8*	-473.7	-498.0	-508.1	-490.2	-122.1	-123.8	-123.2	-125.2	-494.2	123.1	124.6	247.7	288.8
Other current expenditures	-22.9	-31.7	-37.4	-36.9	-53.7	-45.3	-10.7	-15.3	-13.9	-15.7	-55.6	11.9	13.7	25.6	32.0
2. Capital expenditures	-105.1	-111.1	-126.3	-84.0	-96.7	-114.5	-17.4	-31.2	-37.5	-53.1	-139.3	12.0	35.5	47.5	55.8
3. Called guarantees	-2.7	-3.3	-3.7	-7.9	-29.7	-30.1	-8.7	-11.2	-8.2	-11.0	-39.1	8.3	5.8	14.1	15.3
4. Buget lendng	-30.0	-25.0	-38.2	-35.6	-55.4	-2.7	-0.6	-1.0	-1.0	-0.7	-3.3	2.2	5.1	7.3	10.3
CONSOLIDATED BALANCE	**-141.0**	**-163.5**	**-245.2**	**-212.1**	**-258.1**	**-149.1**	**-16.0**	**-2.1**	**13.8**	**-52.8**	**-57.1**	**11.7**	**32.3**	**44.1**	**73.5**

Source: *QM* calculations based on MF data

Annex 2. Serbia: Consolidated General Government Fiscal Operations, 2010-2017 (real growth rates, %)

	2010	2011	2012	2013	2014	2015	2016					2017			
							Q1	Q2	Q3	Q4	Q1-Q4	Q1	Q2	Q1-Q2	I-VII
I PUBLIC REVENUES	**-1.5**	**-4.6**	**0.6**	**-2.2**	**3.2**	***3.1***	**7.4**	**7.8**	**9.2**	**5.6**	***7.5***	***5.3***	***5.5***	***5.4***	***4.9***
1. Current revenues	-1.5	-4.4	0.1	-2.6	3.3	*3.3*	7.3	7.9	8.6	5.8	*7.4*	*5.2*	*5.6*	*5.4*	*5.0*
Tax revenue	-2.5	-4.1	1.0	-1.7	3.5	*0.3*	7.1	9.2	7.5	4.8	*7.2*	*6.1*	*6.0*	*6.1*	*5.0*
Personal income taxes	-3.9	-2.9	2.1	-12.2	-8.1	*-1.2*	4.5	5.2	6.8	1.6	*4.5*	*5.6*	*4.1*	*4.8*	*5.1*
Corporate income taxes	-3.6	3.9	35.1	2.9	17.4	*-15.0*	1.2	19.3	55.8	43.4	*26.9*	*37.6*	*51.9*	*47.8*	*45.9*
VAT and retail sales tax	-0.7	-4.0	0.0	-3.8	5.4	*0.2*	6.4	14.1	3.2	7.7	*7.8*	*2.4*	*0.3*	*1.3*	*1.1*
Excises	4.2	0.6	-1.2	5.1	1.6	*9.4*	22.2	13.8	16.6	-2.9	*11.4*	*9.6*	*-4.0*	*2.3*	*-1.6*
Custom duties	-14.9	-21.5	-14.0	-15.6	-6.5	*5.9*	7.4	9.6	10.2	5.4	*8.1*	*5.2*	*6.6*	*5.9*	*6.6*
Social contributions	-6.5	-3.9	1.9	2.6	3.1	*-2.1*	2.7	3.2	3.7	2.9	*3.2*	*4.4*	*5.1*	*4.7*	*4.5*
Other taxes	14.5	-15.2	-8.8	-5.2	29.2	*8.9*	10.9	0.7	-2.8	12.7	*5.1*	*7.0*	*9.5*	*8.3*	*6.9*
Non-tax revenue	5.8	-6.1	-6.2	-8.7	1.5	*27.9*	8.5	-1.1	15.9	12.8	*9.3*	*-0.5*	*3.1*	*1.2*	*5.2*
II TOTAL EXPENDITURE	**-1.7**	**3.3**	**4.3**	**-0.3**	**5.2**	***-3.2***	**5.7**	**4.9**	**2.3**	**-3.7**	***1.9***	***-1.3***	***-1.7***	***-1.5***	***-1.9***
1. Current expenditures	-2.2	3.1	4.1	-2.7	2.9	*-1.4*	3.7	2.7	0.4	-5.1	*0.2*	*-0.1*	*-2.2*	*-1.2*	*-1.0*
Wages and salaries	-5.9	0.4	2.0	-2.6	-3.1	*-9.7*	-0.4	-0.4	-0.4	-4.5	*-1.4*	*-0.4*	*-0.2*	*-0.3*	*-0.7*
Expenditure on goods and services	-0.3	4.3	1.5	-6.6	6.2	*-1.1*	11.3	13.5	4.2	7.7	*8.9*	*2.1*	*4.5*	*3.4*	*3.6*
Interest payment	-0.3	17.4	41.9	28.8	19.3	*11.2*	11.6	-2.6	-3.4	-10.4	*0.2*	*0.2*	*-23.5*	*-9.6*	*-4.2*
Subsidies	40.6	7.4	29.1	-15.6	13.2	*13.6*	-5.3	0.5	-20.0	-26.2	*-17.3*	*1.8*	*6.9*	*4.7*	*-0.8*
Social transfers	13.9	5.8	-0.1	-2.1	-0.7	*0.5*	1.6	0.8	1.0	-3.7	*-0.1*	*-1.5*	*-2.4*	*-2.0*	*-2.3*
o/w: pensions5)	-3.9	3.9	*4.4*	*-2.3*	*-0.1*	*-4.8*	-0.5	0.2	-0.2	-0.8	*-0.3*	*-2.2*	*-2.9*	*-2.6*	*-2.6*
Other current expenditures	-6.1	23.9	9.9	-8.4	42.6	*-16.7*	30.0	21.8	39.9	4.0	*21.4*	*7.8*	*-14.1*	*-5.1*	*-0.1*
2. Capital expenditures	-11.8	5.3	6.0	-38.2	12.7	*16.8*	64.1	30.7	25.3	3.6	*20.3*	*-33.2*	*9.7*	*-5.5*	*-18.4*
3. Called guarantees	-2.7	-3.3	-3.7	248.7	267.8	*0.1*	25.3	36.0	8.2	43.4	*28.5*	*-7.9*	*-50.2*	*-31.7*	*-30.1*
4. Buget lendng	-30.0	-25.0	-38.2	44.2	52.2	*-95.1*	27.7	19.9	43.7	-3.3	*20.8*	*243.9*	*372.8*	*325.1*	*402.5*

Source: *QM* calculations based on MF data