6. Fiscal Flows and Policy

Fiscal deficit in 2013 ran at RSD 211 billion, or 5.7% of GDP, which is the largest fiscal deficit in the Central and Eastern Europe. Fiscal deficit widened although discretional expenditures (on subsidies, goods and services and capital investments) fell in the second half of 2013, because public revenues went down considerably, both real and as a GDP percent. Indications suggest that the savings partly came from the government's arrears, meaning that FY 2013 deficit is not real but artificially decreased (probably by 0.5% of GDP), and that FY 2014 deficit will be higher by equal percent. Real drop in revenues came from recession, illiquid companies, growing shadow economy, and numerous tax exemptions, granted in the previous years. At the end of January 2014 public debt stood at 63.5% of GDP. Without additional fiscal consolidation measures, and with other macroeconomic indicators unchanged, FY 2014 deficit could exceed projected 7.1% of GDP, in which case the public debt would amount to more than 70% of GDP by the end of the year. Recovery in public finance and economic growth are pre-conditioned by additional permanent savings of about 1% of GDP, which cannot be made without reduction in large items of current public expenditures (on pensions and wages in the public sector), urgent financial and business consolidation of public and state-owned companies and more efficient banking system monitoring by the NBS.

General tendencies and microeconomic implications

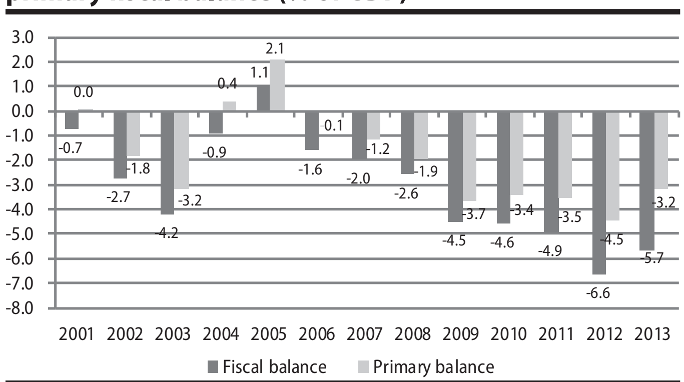
Fiscal deficit in Q4 runs at 4.3% of the quarterly GDP

Consolidated fiscal deficit in Q4 2013 ran at RSD 40.2 billion (about 4.3% of the quarterly GDP), which is below the planned. This partly came from a temporary slowdown in loss of revenues and a considerable reduction in discretional expenditures (on subsidies, goods and services, public investments) as of September 2013, intended to keep the annual fiscal deficit within projections. Reduction in subsidies is economically justifiable, but it should be gradual and accompanied by a sweeping reform in business environment. Likewise, reduction in expenditures on goods and services is justifiable, but it should be made strategically so that it does not cause shortages in the public sector (e.g. in the healthcare system) or the government does not fall into arrears on its liabilities. Reduction in capital expenditures is economically unjustifiable because they are already low (3.4% of GDP) and Serbia's infrastructure is neglected and poor, which adversely affects business environment and economic growth.

Increase in arrears on government liabilities casts a shadow on the reduction in expenditures

Increase in arrears on government liabilities casts a shadow on the reduction in expenditures achieved in Q4 2013. Government in arrears is a blatant example of financial indiscipline, which is unacceptable in an organized market economy, because a government should cover its liabilities on time and thus set an example to all market participants. Under crisis, arrears additionally impair liquidity and plunge the state into deeper recession. Savings based on arrears are temporary, similar to reduction in public investments which fell considerably after the change of local governments in large cities. Payment of the arrears, and rise in local investments, which could occur in the second half of 2014, will widen 2014 fiscal deficit, provided that other conditions remain unchanged.

Graph T6-1. Serbia: Consolidated fiscal balance and primary fiscal balance (% of GDP)[1]



Source: *QM* calculation

1 Primary deficit (deficit without interests) is the difference between the total public revenues and the overall public expenditures subtracted by expenditures on interest payments.

Consolidated fiscal deficit in 2013 ran at 5.7% of GDP, or 6.2% inclusive of arrears

Consolidated fiscal deficit in 2013 amounted to RSD 211 billion, or 5.7% of GDP[1], and if the government covered all its contractual obligations and legal liabilities it would run at 6.2% of GDP. Expenditures on financial rehabilitation of banks and losses incurred by public and state--owned companies (repayment of state-guaranteed loans etc.) take up a considerable portion of the fiscal deficit (0.9% of GDP). Central government ran the largest deficit, while the Health Insurance Fund and local self-governments were in surplus. Central budget deficit is closely related to the pension fund deficit because financial transfers from the central budget to the pension fund in 2013 exceeded consolidated fiscal deficit. Local government budgets were in surplus partly because local public investments fell due to the change of government in several large cities, so this can be taken as temporary.

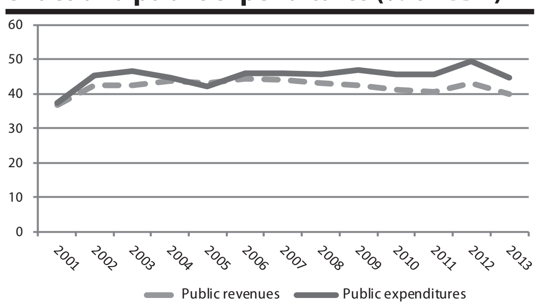
Primary fiscal deficit in 2013 runs at 3.2% of GDP, and inclusive of arrears it rises to 3.7% of GDP

Overall fiscal deficit can be divided into two components: primary fiscal deficit and interest payment. Primary fiscal deficit is a valuable indication of fiscal position of a country because it shows how large the deficit is when subtracted by interest payments. Primary fiscal deficit in 2013 ran at 3.2% of GDP, and inclusive of arrears it rises to 3.7% of GDP. This indicates a large imbalance between revenues and expenditures which is not public debt driven. Primary fiscal deficit shows how large fiscal deficit would be if Serbia's public debt equalled zero. Large primary fiscal deficit suggests that fiscal consolidation in Serbia, and in other countries, must be based primarily on reduction in non-interest expenses (salaries, pensions, subsidies, expenditures on goods and services).

Expenditures on interest payment ran at 2.5% of GDP – without reduction in primary fiscal deficit, Serbia could be faced with a self-generating public debt

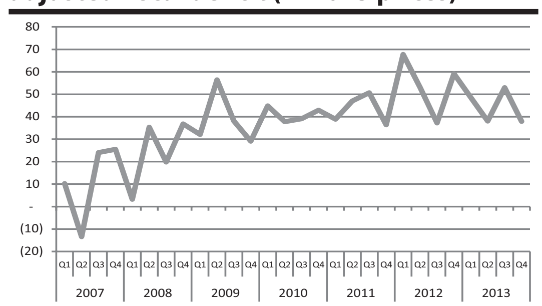
Expenditures on interest payment in 2013 ran at 2.5% of GDP, relative to only 0.7% of GDP in 2008, a pre-crisis year. Increase in these expenditures primarily came from the rise in public debt and interest rates[2]. This means that in order to slow down the growth in expenditures on interest payment it is crucial to curb public debt, which can be achieved through a sharp reduction in primary fiscal deficit. Otherwise, expenditures on interest payment will continue to grow, which could lead to a self-generating public debt, i.e. government borrows to pay interest on the existing debt.

Graph T6-2. Serbia: Consolidated public revenues and public expenditures (% of GDP)



Source: *QM* calculations

Graph T6-3. Serbia: Real seasonally adjusted fiscal deficit (in 2013 prices)



Source: *QM* calculations

To ensure public finance viability, additional permanent savings of 1% of GDP must be made in 2014

Public finance sustainability of a country is assessed according to the level and trends in public debt. Recent empirical research shows that consistency in public debt trends is more important for long-term economic growth and steady pace of economic activity than the debt level.[3] To improve viability of Serbia's public finance and set the basis for a long-term economic growth, reduction in fiscal deficit which would curb public debt in the mid-term (within three years), and reduce it afterwards, is necessary.

1 In the Ministry of Finance's official data, expenditures on financial rehabilitation of banks and companies are not included in the total expenditures. Consequently, official fiscal deficit stands at 4.8% of GDP. We think that for the purpose of transparency and credibility of Serbia's fiscal policy all expenditures should be recognized according to the international accounting standards.

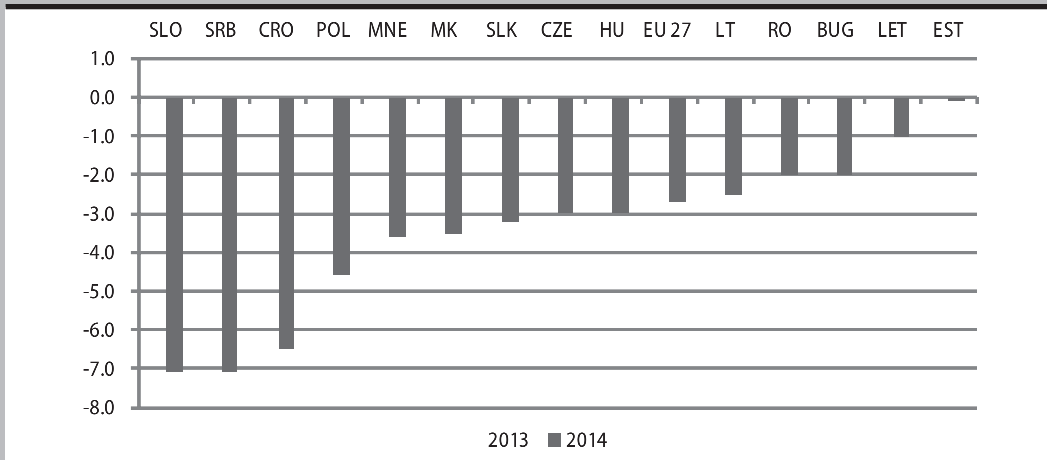
2 Although expenditures on interest payment to GDP ratio also depends on trends in GDP and real dinar exchange rate (about 80% of public debt is in foreign currency), influence of these factors was not big.

3 Pescatori, A., Sandri, D. and J. Simon (2014) „Debt and Growth: Is there a Magic Threshold?". *IMF Working Paper 14/34*

Box 1. Fiscal deficits in the Central and Eastern European countries in 2013 and 2014.

In 2013, two times in a row, Serbia ran the largest fiscal deficit among all Central and Eastern European countries. FY 2014 deficit is projected at 7.1% of GDP, which is twice as large as the average of fiscal deficits in other Central and Eastern European countries. Besides Serbia, only Slovenia and Croatia's fiscal deficits are projected to be this large. However, Slovenia's fiscal deficit mainly comes from the need to intervene in the banking sector, and Serbia and Croatia's fiscal deficits are driven by systemic causes, rather than short-term factors. Additionally, 2014 fiscal deficit is projected to widen relative to 2013 deficit, which is considered bad. There is a risk that without additional fiscal consolidation measures Serbia's 2014 fiscal deficit would be above the projected (failure to restructure the public and state-owned companies etc.). Serbia's 2014 fiscal deficit and its increase rate would thus rank among the largest in Europe.

Graph T6-4. Serbia and other Central and Eastern European countries: Fiscal deficit in 2013 and 2014 (% of GDP)



Source: European Economic Forecasts (2013) and the Ministry of Finance of the Republic of Serbia

...through reduction in salaries, pensions, state-owned companies consolidation and a more efficient banking sector monitoring system

For this purpose, reduction (permanent) in structural fiscal deficit by about 1% of GDP relative to the projections already in 2014 is necessary. This can be achieved only through massive reductions in major current expenditures (on salaries and pensions) in the second half of the year, urgent financial and business restructuring of public and state-owned companies as major state-guaranteed loan users, and more efficient banking sector monitoring by the NBS.

Analysis of the dynamics and structure of public revenues and public expenditures

In 2013 revenues are going down... the drop in revenues slows down in Q4, but temporarily

After a continuous decline in previous quarters, Q4 2013 saw stabilization in public revenues. There was a slight real (seasonally adjusted) rise in public revenues (by 0.3%) in this quarter relative to Q3, and relative to the same period last year, the drop in public revenues slowed down to 0.1%. There was a real drop in annual public revenues by 3%, so 2013 public revenues were by one billion euro bellow the projected (in the Budget 2013). This drop in public revenues relative to the previous year and the projections is driven by recession, insolvency and illiquidity of economy in general, and growing shadow economy.

...and continues in January 2014

In January 2014 real seasonally adjusted public revenues fell by 0.4% relative to December 2013, primarily because revenues from personal income tax, social security contributions, and other tax and non-tax revenues went down.

Downwards trend in revenues from VAT continues...

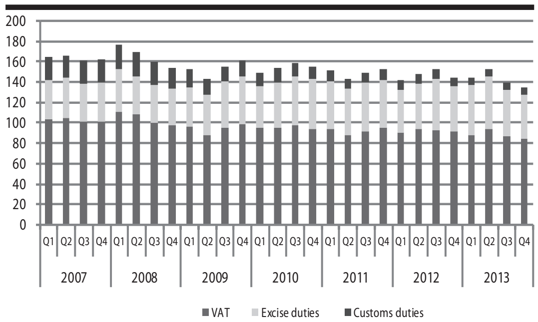
Real seasonally adjusted revenues from VAT went up in Q4 relative to Q3 (by 5.8%), mainly due to the VAT refund done in September, so they were compared against a much lower base (Q3 average). It is therefore more appropriate to make a y-o-y comparison of revenues from VAT in Q4. The data shows that there was a real drop in revenues from VAT in Q4 2013 by 5.2% relative to the same period 2012.

...mainly due to growing shadow economy and tax arrears

Continuation of the downwards trend in revenues from VAT in Q4 under a slight increase in economic activity, almost unchanged real dinar exchange rate, and real and relative (% of GDP) rise in imports suggests that the drop in these revenues was largely driven by growing shadow economy, and financial indiscipline in general. Total revenues from VAT in 2013 suffered a real drop (by 3.8%) relative to 2012, due to decline in domestic demand, slight real appreciation of dinar exchange rate, rise in shadow economy and financial indiscipline, and consequential increase in current tax arrears (tax return has been filed but tax has not been paid). Decline in domestic demand comes from drop in real income and loans, and cannot be attributed to the rise in VAT rate in 2012 (VAT rate increase from 18% to 20% could have caused a drop in domestic demand by 0.3% at the most, which is 1/10 of the total decline in demand).

Excise revenues are going up

Graph T6-5. Serbia: Trends in real consolidated seasonally adjusted revenues from consumption taxes (in 2013 prices)



Source: *QM* calculations

Real seasonally adjusted excise revenues went up slightly in Q4 2013 (by 0.4%) relative to Q3, and when compared to the same period 2012, these revenues grew considerably (by 8.2%). Since there is no indication of a rise in demand for excise goods, or systematic actions against shadow economy in this sector, this increase in excise revenues in Q4 relative to Q3 probably comes from a low base for comparison. There was a real rise in annual excise revenues (by 5.1%) driven by increase in excise rates and high inflation in 2012 (and consequently high indexation of excise duties) which went down in 2013.

Downwards trend in customs revenues continues

Customs revenues (real, seasonally adjusted) went down slightly in Q4 (by 1.8%) relative to the preceding quarter, and suffered a large real drop (by 9.3%) relative to the same period 2012, which is a continuation of a multi-year trend in these revenues. Under a stable real dinar exchange rate and a moderate rise in imports, continuation of the downwards trend in customs revenues (relative to Q3) could be driven by a change in the structure of imports (by commodity and country of origin) to a larger share of commodities with lower tariffs and commodities imported from countries which entered into free trade agreements with Serbia. Annual customs revenues in 2013 suffered a real drop of 15.6% due to a slowdown in imports (domestic demand), slight real appreciation of dinar exchange rate and continuation of a gradual reduction in tariffs on commodities imported from the EU (in accordance with the Stabilization and Association Agreement).

Revenues from personal income tax and social security contributions are rising...

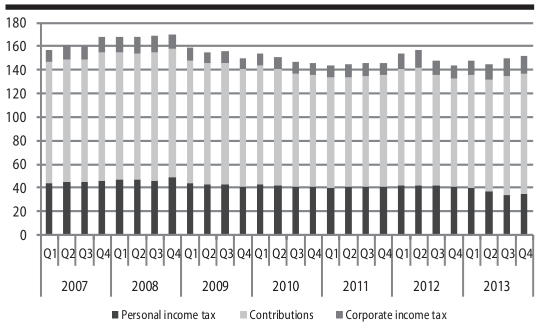
Revenues from personal income tax (real, seasonally adjusted) went up (by 4.9%) in Q4 relative to Q3, but relative to the same quarter 2012, these revenues suffered a large drop (by 11.6%). Revenues from social security contributions (real, seasonally adjusted) went up in Q4 relative to Q3 2013 and Q4 2012 (by 3.1% and 10.9% respectively), primarily due to increase in the rate of pension and disability insurance contributions.

...due to increase in expenditures on wages in the public sector, and probably to good agricultural yields

Rise in revenues from personal income tax and social security contributions in Q4 relative to Q3 was driven by a moderate real increase in public sector wages (due to nominal increase in wages by 0.5% and deflation in the period), growth in the numbers of employees in public sector, pre--term wage payment in the public sector in December (before the solidarity tax came into force) and probably a slight growth in wage payments to private sector agricultural workers, due to good agricultural yields. Rise in revenues from social security contributions and decline in revenues from personal income tax in Q4 2013 relative to the same period 2012. Besides this, increase in social contributions revenues is consequence of the reduction in wage tax rate (and increase in non-taxable part of wage) and rise in social security contributions rate, as of June 2013. Annual revenues from personal income tax in 2013 suffered a large real drop (by 12.2%), and revenues from social security contributions went up moderately (by 2.6%) relative to 2012. This is the net effect of the decline in formal employment and real personal income, and redistribution of tax burden from personal income tax to social security contributions.

Slight fall in revenues from corporate income tax in Q4 could indicate deterioration of business performance

Graph T6-6. Serbia: Trends in consolidated seasonally adjusted revenues from taxes on production factors (in 2013 prices)



Source: *QM* calculation

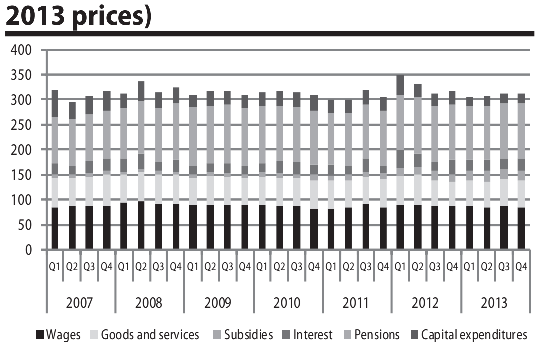
There was a moderate fall in revenues from corporate income tax in Q4 relative to Q3 (by 0.9%), but when compared with the same period 2012, these revenues went up considerably (by 44.9%). Annual (real) revenues from corporate income tax in 2013 went up moderately (by 2.9%). The fall in corporate income tax in Q4 relative to Q3 comes from illiquidity of Serbian economy, and could be an indicator of continuous deterioration of business performance, based on which companies estimated that the overall profit in 2013 would fall short of the projections and revised (down) their corporate income tax advances. Rise in revenues from corporate income tax in 2013 relative to 2012 primarily came from the increase in corporate income tax rate, as of January 2013. Rise in revenues from corporate income tax mainly came from the increase in corporate income tax rate from 10% to 15%, which affects the amount of corporate income tax advances paid in 2013.

Other tax revenues (real seasonally adjusted) went up slightly in Q4 relative to Q3 (by 0.8%), which could indicate a more efficient use of direct and transferred public revenues by local governments, due to loss of revenues from wage tax and other quasi-fiscal charges. Non-tax revenues (real seasonally adjusted) suffered a slight drop in Q4 (by 0.6%), because some companies failed to pay dividends to the government. Observed annually, other tax revenues and non-tax revenues suffered a moderate fall (by 5.2% and 8.7% respectively) in 2013 relative to 2012 due to abolition of quasi-fiscal charges at the end of 2012 and deteriorated business performance of public and state-owned companies (and consequential drop in revenues from dividend).

There is a moderate drop in public expenditures in Q4, driven by reduction i discretional expenditures ... however, arrears are going up

Real seasonally adjusted public expenditures went down moderately (by 3.5%) in Q4 relative to Q3, and suffered a considerable real drop (by 5.8%) relative to the same period last year. Real annual public expenditures in 2013 went down by 5.5% relative to 2012. Reduction in overall expenditures in Q4 came from a massive reduction in subsidies, reduction in capital investments and slight reduction in expenditures on goods and services and expenditures on employees. Discretionary expenditures went down partly because some projects were justifiably cancelled, and partly because some projects were delayed or payments for procured goods and services were postponed (arrears). All savings based on postponement of vital projects or delayed payments for procured goods and services could widen 2014 deficit.

Graph T6-7. Serbia: Trends in consolidated seasonally adjusted public expenditures (in 2013 prices)



Source: *QM* calculations

Reduction in subsidies came from abolition of investment and employment incentives and reduction in subsidies to municipal public companies

To keep the fiscal deficit within projections, the government reduced discretionary expenditures in Q4. Accordingly, real seasonally adjusted expenditures on subsidies went down in Q4 relative to Q3 (by 11%), and the drop was even larger when compared with the same period 2012 (by 29.5%). Due to a considerable reduction in subsidies at the end of the year, total expenditures on subsidies in 2013 went down by 15.6% relative to 2012. Reduction in expenditures on subsidies was made through abolition of investment and employment incentives, reduction in incentives to tourism and similar, and through reduction in local government subsidies to municipal public companies. Some of these savings are temporary, because some incentive programmes were abolished in Q4 (investment and employment incentives etc.), but similar incentive schemes have been announced.

Reduction in subsidies is desirable, but it should be gradual and accompanied by reforms in business environment

Reduction in massive, fiscally unviable subsidies was necessary, but, for the purpose of predictability of business environment and to prevent a sharp drop in foreign direct investments, it should have been made gradually and accompanied by sweeping reforms in business environment.

Reduction in public expenditures in Q4 came from reduction in capital expenditures. Real seasonally adjusted capital expenditures in this quarter were much lower than in Q3 (by 24.2%), and by 46.7% lower than in the same quarter 2012. Total capital expenditures in 2013 went down by 38.2% relative to 2012, and amounted to only 3.4% of GDP, which is much below the necessary level. Reduction in expenditures aimed at keeping fiscal deficit within the projected levels is justifiable, but it should not be made through reduction in investments in physical and human capital (public investments and education), as these are drivers of long-term economic growth.

Capital expenditures went down in Q4, which is economically unjustifiable

Expenditures on goods and services went down, too

Expenditures on goods and services (real seasonally adjusted) went down in Q4 relative to Q3 by 4.7%, and when compared with the same period 2012, they grew by 4%. Total expenditures on goods and services in 2013 fell by 6.6%, which is in nominal amount (RSD 1.3 billion) much below the savings from the new public procurement system (tens of billions of dinars) announced earlier. These expenditures fell in Q4 relative to Q3 because procurement of goods and services that are not crucial for the functioning of public sector was suspended and/or reduced to keep fiscal deficit at the projected level. Reduction in these expenditures was also made through pooled procurement of medicines and other medical supplies. Reductions in expenditures on goods and services are welcome, as long as they do not jeopardize functioning of the public sector, or cause accumulation of arrears.

Expenditures on employees fell slightly

Real seasonally adjusted expenditures on employees in Q4 were by 2.5% lower than in Q3, and by 2.1% lower than in Q4 2012. Trends in expenditures on employees in Q4 were divergently affected by the wage increase of 0.5% in October, on one hand, and specific dynamics of wage payments in healthcare system, and government's greater caution about hiring new employees and wages, driven by establishment of the register of public sector employees which allows greater control in this area, on the other.

Expenditures on pensions went up slightly in Q4, due to indexation of the nominal amount of pensions and deflation

Expenditures on pensions (real seasonally adjusted) in Q4 were by 0.5% higher than in Q3, and by 1.2% higher than in Q4 2012. Rise in expenditures on pensions in Q4 is driven by the increase in numbers of pensioners and pension indexation in October (by 0.5%). Under a slight deflation, these factors caused a considerable real rise in these expenditures. There was a real drop in total expenditures on pensions in 2013 of 2.3%, because indexation did not keep pace with inflation. Amendments to the Budget System Law adopted at the end of December provide that the low indexation of pensions and wages will continue in 2014 and 2015 (by 0.5% in October and April). However, under low inflation this restrictive indexation policy will not bring the necessary real and relative savings. Therefore, a credible fiscal consolidation requires nominal reduction in pensions and wages.

Expenditures on interest payment went up because semi-annual coupons fell due

Real seasonally adjusted expenditures on interest payment in Q4 rose by 10% relative to Q3, and by 26.7% relative to the same quarter 2012, because semi-annual coupons on euro-denominated bonds fell due.

...total expenditures on interest payment in 2013 increased sharply due to increase in Serbia's public debt and tougher borrowing conditions

Total expenditures on interest payment went up in 2013 relative to 2012 by 28.8%. This increase came from rise in the absolute amount of public debt, change in public debt structure (share of cheap debt, such as old foreign currency savings, is shrinking in favour of new, expensive loans), and tougher borrowing conditions (due to large fiscal deficit, and to a smaller extant, to turmoil in the world financial markets).

Fiscal trends by government levels

Central government (exclusive of the Health Insurance Fund) runs deficit, and sub-central governments are in surplus

In 2013 central government (exclusive of the Health Insurance Fund of the Republic of Serbia) ran deficit, and sub-central governments (Autonomous Province of Vojvodina and local self-governments) were in surplus. Central government budget deficit in 2013 was within the levels projected in the Budget rebalance. The same goes for the Pension and Disability Insurance Fund and National Employment Service.

The Health Insurance Fund was in large surplus in 2013 due to specific dynamics of wage payment and reduction in expenditures on medicines

On the other hand, the Health Insurance Fund posted surplus of almost RSD 9 billion in 2013, which is much larger than planned. This is due to a specific dynamics of wage payment and reduction in expenditures through pooled procurement of medicines and other medical supplies. These savings came from the new procurement system, but indications show that it also caused a shortage in some items and led to arrears.

Effects of 2011 fiscal decentralization have not worn off... further redistribution of revenues/expenditures of 0.1-0.2% is possible

Budget of the Autonomous Province of Vojvodina was in surplus because some capital projects were slowed down. Local self-governments were in surplus of RSD 6.3 billion in 2013, although they were expected to run deficit. This could indicate that the vertical imbalance caused by 2011 fiscal decentralization has not been corrected. However, given the scope of local self-government competencies, real amount of the surplus revenues could deviate from the achieved budget surplus, because according to the State Audit Institution local self-governments are obliged to accumulate the full amount of funds for any capital project before inviting tenders for it. On the other hand, aware of the risk of further redistribution of funds from local to central government, local self-governments probably increased expenditures in Q4 to reduce the nominal amount of their budget surplus. However, taking all this into account, we believe that further redistribution of revenues (from local to central government) or competencies (from the central to the local level) of 0.1-0.2% of GDP (RSD 4-8 billion) is possible, without jeopardizing the functioning of local governments or accumulating arrears.

Table T6-8. Serbia: Fiscal surplus (deficit) at different levels of government (bn. RSD, current prices)

Year	*Budget of Republic*	*Pension fund*	*National Employment Service*	*Health fund*	*Vojvodina budget*	*Localself-governments*
2010	-108.0	-1.0	-0.1	1.9	-9.6	-11.5
2011	-144.3	0.2	1.3	2.1	-0.7	-15.6
2012	-213.0	-0.4	0.8	4.0	1.1	-0.3
2013	-194.4	-1.2	-0.5	8.7	1.3	6.3

Source: *QM* calculations based on the Ministry of Finance's data

Central government and local self-governments budget revenues are going down, and social security funds revenues are rising

Central government and local self-government budget revenues suffered a real drop (by 2.5% and 5.5% respectively) in Q4 2013 relative to the same period 2012. On the other hand, the Health Insurance Fund and Pension and Disability Insurance Fund's revenues went up, based on social security contributions. This decline in central government and local self-government budget revenues and rise in the Pension and Disability Insurance Fund's revenues mainly came from reduction in tax rate on wages and increase in pension and disability pension contributions as of June 2013. Additionally, a downwards trend in local budget non-tax revenues continues, as a consequence of the reform in quasi-fiscal charges system carried out in 2012. Revenues from property tax went up slightly (by 5.5%), which could indicate that local governments increased their efforts to collect this tax more efficiently, and thus make up the loss of revenues.

There was a real drop in expenitures at all government levels in Q4, due to fall in revenues...

There was a real drop in expenditures at all government levels in Q4 2013 relative to the same period 2012. Central government and loacal self-governments made the largest reduction in expenditures (12.8% and 6.2% respectively). Cut in central government expenditures came from reduction in direct subsidies, slowdown in public investments, and reduction in other discretionary expenditures intended to keep the fiscal deficit at the projected level.

...reduction in local government expenditures primarily comes from a cut in subsidies and capital investments

Local self-governments tried to make up the loss of revenues through a cut in subsidies, which is justifiable, but also through reduction in capital investments, which is not good from the aspect of local economic development. On the other hand, reduction in the largest (unproductive) current expenditures at the local level – expenditures on wages and goods and services – was negligible (expenditures on goods and services even went up slightly). Reduction in capital expenditures is the least economically justifiable way of saving, but under large deficit it is reasonable to postpone some capital projects and prioritize them.

The foregoing fiscal trends indicate that local self-government and the Autonomous Province of Vojvodina funding systems need to be (re)organized, meaning that the funding should be predictable (primarily the amount of transfers), and allocation of funds should be in proportion with the efforts local self-governments make to collect its tax revenues, and the efficiency in revenue use, intended to encourage them to increase local public investments, rather than expenditures on employees, goods and services and subsidies.

Public debt dynamics

In January 2014 Serbia's public debt stood at EUR 20.2 billion (63.5% of GDP)

According to the Ministry of Finance's official data, Serbia's public debt stood at EUR 20.2 billion (63.5% of GDP) at the end of January 2014, which is by EUR 1.3 billion larger than at the end of Q3 2013. This increase came from the rise in direct debt. Public debt-to-GDP ratio worsened in this period (by 3.6% of GDP) primarily due to rise in absolute amount of public debt, and small real appreciation of dinar exchange rate in this period, while real GDP growth was too low to improve it. Increase in public debt in the period October-January was much larger than fiscal deficit in this period (EUR 350 million), because the government issued a large amount of euro-denominated bonds in November to obtain the funds needed to finance the deficit in the following quarters. Increase in government deposits in the period October-January confirms this (see Monetary flows and policy).

Table T6-9. Serbia: Public debt[1] 2000-2014.

	Amount at the end of period, in billions EUR										
	2000	2005	2006	2007	2008	2009	2010	2011	2012	2013	Jan-14
I. Total direct debt	14.17	9.62	8.58	8.03	7.85	8.46	10.46	12.36	15.07	17.3	17.4
Domestic debt	4.11	4.26	3.84	3.41	3.16	4.05	4.57	5.12	6.5	7.0	7.1
Foreign debt	10.06	5.36	4.75	4.62	4.69	4.41	5.89	7.24	8.6	10.2	10.4
II. Indirect debt	-	0.66	0.80	0.85	0.93	1.39	1.71	2.11	2.60	2.8	2.8
III. Total debt (I+II)	**14.17**	**10.28**	**9.38**	**8.88**	**8.78**	**9.85**	**12.17**	**14.47**	**17.67**	**20.1**	**20.2**
Public debt / GDP[2]	**169.3%**	**50.2%**	**36.2%**	**29.4%**	**25.6%**	**31.3%**	**41.5%**	**45.1%**	**59.3%**	**61.2%**	**62.3%**
Public debt / GDP (QM)[3]	**169.3%**	**52.1%**	**37.8%**	**30.9%**	**29.2%**	**34.8%**	**44.6%**	**46.9%**	**60.0%**	**62.4%**	**63.5%**

Source: Ministry of Finance's data and *QM* calculations

There is a growing interest among portfolio investors in Serbian treasury bills due to high real yields...

Direct public debt rose by EUR 1.3 billion in the period October 2013-January 2014. More than a half of this amount comes from borrowing with international financial institutions (about EUR 750 million), and the rest comes from domestic borrowing (about EUR 500 million). Quite large increase in domestic borrowing, primarily driven by issuance of treasury bills, is a continuation of the trend detected in Q3 and comes from quite stable dinar exchange rate and high interest rate on treasury bills, which provides high yields.

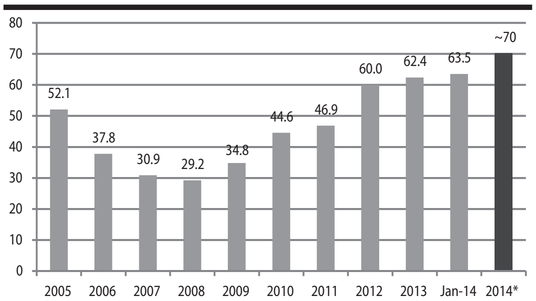
...but there is a risk that they could withdraw suddenly, so alternative sources of funds must be provided

However, there is a risk that portfolio investors could withdraw suddenly due to a growing uncertainty in the world financial markets (caused by the Fed's less expansionary monetary policy) and lack of a strong fiscal consolidation in Serbia. Alternative sources of funds must therefore be provided, to secure budget liquidity.

Indirect debt is going down, but the key drivers of its long-term growth have not been eliminated

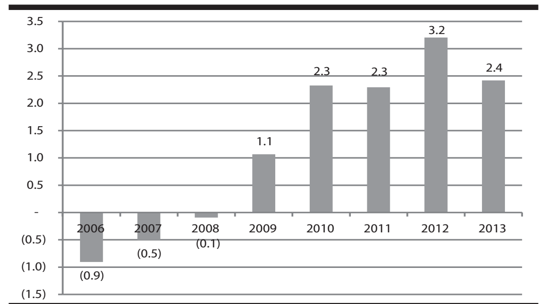
After stagnation in Q3, indirect public debt went down slightly (by EUR 100 million) in the period October 2013-January 2014. This is good because the upwards trend in indirect debt has been reversed after many years. However, this stagnation and decrease is temporary because the key drivers of the growth in public debt have not been eliminated. The continuous growth in public debt is mainly driven by government guaranteed borrowing by public and state-owned enterprises (Srbijagas, Železara, Galenika, EPS etc.). Quite large amount of government guarantees on loans to these companies was issued in the first half of 2013, which enabled them finance their operations (primarily Srbijagas and Železara) by the end of 2013 and at the beginning of 2014. According to the Budget of the Republic of Serbia for 2014, government will issue guarantees on loans to these enterprises with which they will be able to fund their operations by mid 2014, the deadline for their restructuring which should lead to their long-term financial viability (Srbijagas) and privatization (Železara, Galenika). Since the restructuring plans have not been developed yet, it is quiet unlikely that these companies will be enabled to function on their own by mid 2014, meaning that further issuance of state guarantees will be needed. Annual expenditures on financial support to these enterprises in consolidated budget are growing and have amounted to hundreds of millions of euros per year. Financial and business consolidation of these enterprises is therefore crucial for a comprehensive fiscal consolidation in Serbia. Otherwise, reduction in expenditures on other items will be offset by growing expenditures on financial support to these enterprises.

Graph T6-10. Trends in public debt in Serbia (% of GDP)



Source: *QM* calculations

Graph T6-11. Growth in public debt in Serbia (Euro bn)



Source: *QM* calculations

Public debt dynamics are highly unfavourable. Four years in a row, Serbia's public debt increased by more than EUR 2.3 billion annually (average annual growth in public debt in the period 2010-2013 was EUR 2.6 billion), and the increase was larger in 2012 and 2013 than in the preceding years. Relative growth in public debt (as GDP percentage point) was somewhat slower, due to a moderate real appreciation of dinar-to-euro exchange rate and modest cumulative growth in GDP.

Public debt will amount to 70% of GDP at the end of 2014

With 2014 fiscal deficit at the projected level (around 7% of GDP), and with steady dynamics in indirect debt, with inflation at the projected level, and with unchanged real dinar exchange rate and steady real GDP, Serbia's public debt will amount to 70% of GDP at the end of 2014. Potential arrangement with the IMF is conditional on the additional reduction in 2014 fiscal deficit, by 1% of GDP. In that case, public debt could be slightly below 70% of GDP at the end of the year. On the other hand, with notable depreciation of dinar exchange rate, decline in economic activity or increase in indirect debt (financial support to state-owned companies, banks etc.), public debt could be larger than projected.

Appendices

Annex 1. Serbia: Consolidated General Government Fiscal Operations[1)], 2008-2013 (nominal amounts, bn RSD)

	2008	2009	2010	2011	2012					2013				
					Q1	Q2	Q3	Q4	Q1-Q4	Q1	Q2	Q3	Q4	Q1-Q4
I PUBLIC REVENUES	**1,145.9**	**1,146.5**	**1,223.4**	**1,302.5**	**312.6**	**339.7**	**355.1**	**398.0**	**1,405.4**	**330.0**	**362.4**	**369.1**	**406.4**	**1,467.8**
1. Current revenues	1,143.1	1,139.2	1,215.7	1,297.9	311.7	337.7	354.0	390.4	1,393.8	327.3	361.3	367.6	405.0	1,461.3
Tax revenue	1,000.4	1,000.3	1,056.5	1,131.0	276.3	298.1	315.6	335.9	1,225.9	296.4	321.8	325.8	352.5	1,296.4
Personal income taxes	136.5	133.5	139.1	150.8	35.8	41.2	41.4	46.7	165.3	38.2	39.8	35.9	42.1	156.1
Corporate income taxes	39.0	31.2	32.6	37.8	22.9	10.9	10.3	10.7	54.8	18.4	11.0	15.4	15.8	60.7
VAT and retail sales tax	301.7	296.9	319.4	342.4	79.7	90.1	94.4	103.3	367.5	87.3	98.7	94.6	99.9	380.6
Excises	110.1	134.8	152.2	170.9	34.6	40.6	54.9	51.0	181.1	42.5	53.7	52.3	56.3	204.8
Custom duties	64.8	48.0	44.3	38.8	7.7	9.0	9.3	9.8	35.8	7.3	7.9	8.2	9.1	32.5
Social contributions	312.7	318.8	323.0	346.6	85.9	94.6	94.5	103.9	378.9	93.4	99.7	107.7	117.6	418.3
Other taxes	35.6	37.1	46.0	43.5	9.7	11.7	10.8	10.4	42.6	9.3	10.9	11.6	11.7	43.5
Non-tax revenue	142.7	138.8	159.2	166.9	35.4	39.6	38.4	54.5	167.9	30.9	39.6	41.9	52.5	164.9
2. Capital revenues	1.4	0.9	0.3	2.0	0.6	1.3	0.8	6.0	8.7	1.9	0.5	0.6	0.5	3.5
	0.0													
II TOTAL EXPENDITURE	**-1,195.7**	**-1,248**	**-1,329.9**	**-1,435.9**	**-362.8**	**-391.1**	**-389.2**	**-463.1**	**-1,606.2**	**-364.3**	**-402.6**	**-422.1**	**-445.0**	**-1,633.9**
1. Current expenditures	-1,089.6	-1,155	-1,224.8	-1,324.8	-337.5	-368.6	-359.3	-414.6	-1,479.9	-350.9	-385.0	-395.4	-418.6	-1,549.8
Wages and salaries	-293.2	-302.0	-308.1	-342.5	-85.5	-94.4	-91.2	-103.6	-374.7	-93.8	-98.1	-97.5	-103.4	-392.7
Expenditure on goods and services	-181.2	-187.4	-202.5	-216.3	-51.2	-62.9	-53.8	-67.7	-235.7	-49.7	-55.3	-60.0	-71.9	-236.9
Interest payment	-17.2	-187.4	-34.2	-44.8	-15.4	-13.4	-23.3	-16.2	-68.2	-18.9	-27.5	-27.2	-20.9	-94.5
Subsidies	-77.8	-22.4	-77.9	-80.5	-22.6	-25.2	-19.6	-44.2	-111.5	-19.0	-22.0	-28.4	-31.8	-101.2
Social transfers	-496.8	-63.1	-579.2	-609.0	-154.9	-161.1	-163.5	-173.0	-652.5	-162.4	-173.0	-172.6	-179.5	-687.6
o/w: pensions [5)]	*-331.0*	-556.4	*-394.0*	*-422.8*	*-112.5*	*-117.8*	*-119.2*	-124.1	-473.7	-120.0	-124.6	-125.3	-128.2	-498.0
Other current expenditures	-23.5	-387.3	-22.9	-31.7	-7.9	-11.7	-8.0	-9.8	-37.4	-7.1	-9.1	-9.6	-11.1	-36.9
2. Capital expenditures	-106.0	-24.0	-105.1	-111.1	-25.3	-22.5	-30.0	-48.6	-126.3	-13.4	-17.6	-26.7	-26.4	-84.0
	0													
III "OLD" DEBT REPAYMENT, GOVERNMENT NET LENDING AND	**-19.1**	**-20**	**-29.9**	**-24.9**	**-4.7**	**-5.7**	**-2.3**	**-3.9**	**-16.6**	**-3.1**	**-3.9**	**-4.1**	**-1.6**	**-12.7**
IV TOTAL EXPENDITURE, GFS (II+III)	**-1,214.8**	**-1,268.3**	**-1,359.8**	**-1,460.8**	**-367.5**	**-396.7**	**-391.6**	**-467.0**	**-1,622.8**	**-367.3**	**-406.5**	**-426.1**	**-446.6**	**-1,646.5**

Source*: QM*

Annex 2. Serbia: Consolidated General Government Fiscal Operations[1)], 2008-2013 (real growth in %)

	2008	2009	2010	2011	2012					2013				
					Q1	Q2	Q3	Q4	Q1-Q4	Q1	Q2	Q3	Q4	Q1-Q4
I PUBLIC REVENUES	**3.3**	**-8.7**	**-1.5**	**-4.6**	**1.7**	**4.8**	**-0.8**	**-3.2**	**0.6**	**-5.8**	**-3.2**	**-2.7**	**0.1**	**-3.0**
1. Current revenues	3.5	-9.1	-1.5	-4.4	1.7	4.5	-0.9	-4.4	0.1	-6.2	-2.9	-2.8	1.7	-2.6
Tax revenue	3.7	-8.8	-2.5	-4.1	1.9	5.3	1.9	-4.4	1.0	-4.2	-2.1	-3.4	2.9	-1.7
Personal income taxes	6.3	-10.8	-3.9	-2.9	4.6	4.6	1.3	-1.6	2.1	-4.9	-12.3	-18.9	-11.6	-12.2
Corporate income taxes	18.5	-27.0	-3.6	3.9	51.5	39.9	25.4	15.0	35.1	-28.2	-7.9	39.6	44.9	2.9
VAT and retail sales tax	2.5	-10.2	-0.7	-4.0	-4.0	6.9	0.9	-3.7	0.0	-2.1	-0.6	-6.2	-5.2	-3.8
Excises	0.7	11.6	4.2	0.6	-5.7	-3.0	8.5	-7.0	-1.2	9.5	20.1	-10.9	8.2	5.1
Custom duties	1.8	-32.4	-14.9	-21.5	-18.6	-8.6	-11.4	-17.6	-14.0	-15.3	-20.5	-16.9	-9.3	-15.6
Social contributions	4.3	-7.0	-6.5	-3.9	4.8	6.1	0.7	-3.4	1.9	-3.0	-4.4	6.7	10.9	2.6
Other taxes	-2.3	-4.9	14.5	-15.2	-9.7	7.6	-12.0	-19.2	-8.8	-14.2	-15.6	0.2	10.2	-5.2
Non-tax revenue	2.6	-11.3	5.8	-6.1	0.1	-1.1	-19.0	-4.3	-6.2	-22.0	-9.4	2.1	-5.4	-8.7
2. Capital revenues	-76.8	-41.4	-66.8	468.2	124.1	259.1	176.7	373.3	304.5	159.4	-63.6	-31.7	-91.3	-63.0
II TOTAL EXPENDITURE	**4.5**	**-4.8**	**-1.7**	**3.3**	**10.3**	**9.2**	**-2.9**	**1.5**	**4.3**	**-10.4**	**-6.6**	**1.5**	**-5.8**	**-5.5**
1. Current expenditures	6.9	-3.3	-2.2	3.1	8.2	9.3	-1.7	1.4	4.1	-7.2	-5.2	3.0	-1.0	-2.7
Wages and salaries	10.9	-6.0	-5.9	0.4	6.6	6.3	-5.7	1.4	2.0	-2.1	-5.7	0.0	-2.1	-2.6
Expenditure on goods and services		-5.7	-0.3	4.3	9.4	15.0	-2.3	-11.4	1.5	-13.4	-20.3	4.5	4.0	-6.6
Interest payment	-2.8	-5.7	-0.3	17.4	48.1	6.6	93.4	23.4	41.9	9.8	86.3	9.5	26.7	28.8
Subsidies	-13.3	19.0	40.6	7.4	42.6	56.4	-36.2	82.9	29.1	-24.7	-20.7	35.9	-29.5	-15.6
Social transfers	10.1	-26.0	13.9	5.8	3.8	2.9	-0.3	-6.1	-0.1	-6.4	-2.5	-1.2	1.7	-2.1
o/w: pensions5)	*9.5*	2.2	-3.9	3.9	*8.4*	*7.4*	*3.1*	*-0.5*	*4.4*	*-4.8*	*-4.1*	*-1.6*	*1.2*	*-2.3*
Other current expenditures	14.9	6.7	-6.1	23.9	-17.1	36.8	12.2	11.8	9.9	-19.6	-29.5	12.4	10.6	-8.4
2. Capital expenditures	-4.3	-6.7	-11.8	5.3	48.7	8.3	-14.9	2.3	6.0	-52.9	-29.0	-16.6	-46.7	-38.2
III "OLD" DEBT REPAYMENT, GOVERNMENT NET LENDING AND RECAPITALIZATIONS	**12.3**	**-2.4**	**35.2**	**-25.6**	**-18.3**	**-45.2**	**-54.7**	**-26.3**	**-37.9**	**-41.7**	**-37.6**	**63.2**	**-58.5**	**-29.0**
IV TOTAL EXPENDITURE, GFS (II+III)	**4.6**	**-4.8**	**-1.1**	**-3.8**	**9.8**	**7.7**	**-3.5**	**1.2**	**3.6**	**-10.8**	**-7.0**	**1.8**	**-6.2**	**-5.7**

Source: *QM*

Annex 3. Serbia: Real annual rates of growth in public revenues and public expenditures, by the levels of government

	Q4 2013/Q4 2012			
	Consolidated budget	Budget of Republic	Health Fund	Local self-governments
A Total public revenues (I)+(II)+(III)+(IV)	**0.1**	**-2.5**	**0.9**	**-5.5**
I Current revenues (1)+(2)	1.7	0.4	1.4	-8.7
1. Tax revenues	2.9	0.2	2.3	-5.9
1.1. Customs	-9.3	-9.3	-	-
1.2. Personal income tax	-11.6	-13.3	-	-10.6
1.3. Corporate income tax	44.9	43.9	-	-
1.4. VAT	-5.2	-5.2	-	-
1.5. Excise duties	8.2	8.2	-	-
1.6. Property taxes	5.5	-	-	5.5
1.9.Other taxes	10.2	4.4	-	26.3
1.10. Social security contributions	10.9	-	2.3	-
2. Non-tax revenues	-5.4	1.4	-26.4	-16.2
II Capital revenues	-91.3	-	-66.3	-3.3
III Transfers from the other levels of government	-	-	-0.3	8.0
IV Donations	-49.4	-80.1	-	184.9
B Total public expenditures (I)+(II)+(III)+(IV)	**-5.8**	**-12.8**	**-1.0**	**-6.2**
I Current expenditures	-1.0	-7.6	-1.0	-1.1
1.1 Wages	-2.1	-3.0	-1.6	-0.3
1.2. Goods and services	4.0	6.2	-0.6	1.2
1.3 Interest payments	4.0	27.9	-91.7	-0.2
1.4 Subsidies	26.7	-37.1	0.0	-14.4
1.5 Social insurance and social assistance	-29.5	11.6	6.6	-5.4
1.6 Transfers to the other levels of government	1.7	-13.9	-	-
1.7 Other current expenditures	10.6	-11.2	-36.4	31.7
II Capital expenditures	-46.7	-41.1	-18.6	-26.2
III Strategic reserves		-99.0	-	-9.2
IV Net lending	-20.7	-61.0	-	665.0

Source: *QM*