6. Fiscal flows and policy

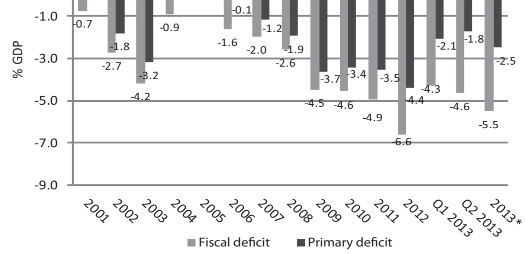
Fiscal deficit in Q2 2013 amounted to RSD 44.2 billion (4.6% of the quarterly GDP), while in the first two quarters of the year it totaled RSD 80.9 billion, (4.5% of GDP). Although public revenues went up slightly in Q2 relative to Q1, they are still below the targeted, and suffered a considerable real drop (by 3.2%) compared with the same period last year, so a more substantial and steadier rise in public revenues does not seem to be on the way. Real public expenditures in Q2 went down considerably compared with the same period last year, but when compared with non-election years, without high election spending, they are still heavy. Furthermore, expenditures in Q2 slightly went up compared with Q1, primarily due to a considerable rise in expenditures on interest payments and a slight increase in expenditures on pensions. Measures intended to reduce the deficit by the end of 2013, on average by 2.5-3 billion dinars per month, or by around 0.5-0.6% of GDP annually, were adopted at the end of May and in June. However, since seasonal expenditures are extremely high in the last quarter, fiscal deficit in 2013 is expected to run at 5.5-6% of GDP according to domestic methodology, or at 7-7.5% of GDP according to international GFS methodology, if other variables remain unchanged. A stronger slowdown in public debt growth in 2014 requires reduction in fiscal deficit by at least 2-2.5% of GDP (down to 3.5-4% of GDP according to domestic methodology). The measures that have been implemented, and the announced measures agreed on by the Government, will not suffice to achieve the desired fiscal deficit reduction – additional measures that would secure a reduction of 1-1.5% of GDP are necessary. Adoption of a credible 2014 Budget is therefore critical to the success of the overall fiscal consolidation. Public debt stood at 60.5% of GDP at the end of July, but this slight drop in public debt compared with Q1 is short-lived. Public debt is expected to total 63-64% of GDP at the end of the year, on the assumption that macroeconomic and fiscal projections would fulfill.

General tendencies and macroeconomic implications

Fiscal deficit in Q2 runs at 4.6% of GDP

Consolidated fiscal deficit in Q2 2013 ran at 44.2 billion dinars (about 4.6% of the quarterly GDP), while the fiscal deficit in the first two quarters of the year totaled RSD 80.9 billion, 4.5% of the semi-annual GDP. Considerable real y-o-y drop in public revenues continued in Q2 and they came below projections, although seasonally adjusted data indicates a slight real growth compared with Q1. This growth is primarily due to the new dynamics of revenues from consumption tax caused by VAT system reform and a slight real depreciation of the dinar exchange rate. Furthermore, a moderate recovery in economic activity and a slight rise in imports stimulated the growth in public revenues in Q2. However, the growth in revenues in Q2 is not seen as a sign of a lasting recovery in public revenues because it is mostly caused by specific and one-off factors. Additionally, the Tax Administration took a new approach to tax collection as of May 2013, switching from announcements of future reforms and implementation of ad hoc measures, to actual enhancement of fiscal discipline, which is considered encouraging. However, these activities have not yet produced the desired effects, and, apart from the improved performance of the Tax Administration, a marked reduction in shadow economy and tax evasion requires a greater overall financial discipline in the state. Public expenditures in Q2

Graph T6-1. Serbia: Consolidated fiscal balance and primary fiscal balance[1]

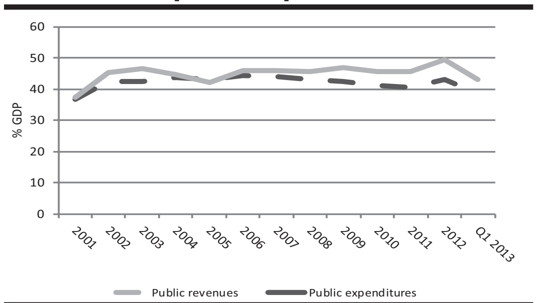


Source: QM calculations.

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.

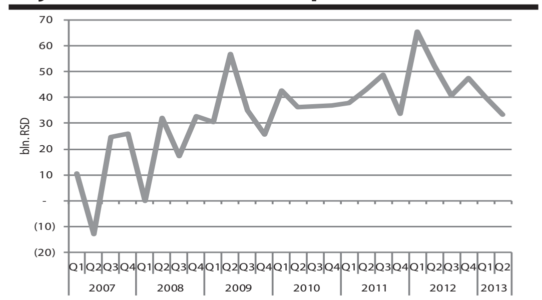
went down moderately compared with the same period last year, but when compared with non-election years without high election spending (2012 was the election year), they are still heavy. Additionally, Q2 saw a slight (real seasonally adjusted) rise in public expenditures compared to Q1 2013. Overall public expenditures went up (relative to Q1) due to a slight rise in expenditures on pensions caused by indexation, and the strong rise in expenditures on interest payments because euro-denominated bonds issued in November 2012 fell due. The difference between the fiscal deficit and the primary deficit widens, which indicates the relative rise in expenditures on interest payments. More rapid rise in expenditures on interest payments detected in the preceding quarters, which will probably continue in the following period, suggests the need for a massive reduction in fiscal deficit in order to prevent public debt become self-generating, i.e. to prevent further borrowing to pay interest on the existing debt.

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



Source: *QM* calculations

Graph T 6-3. Serbia: Real seasonally adjusted fiscal deficit (in prices in 2012)



Source: *QM* calculations

Fiscal deficit in 2013 will run at 5.5-6% of GDP, according to domestic methodology

In the 2013 Budget rebalance adopted in July, consolidated fiscal deficit in 2013 is projected at 5.2% of GDP. The measures adopted mid 2013 should cut the deficit, on average, by about 2.5-3 billion dinars per month by the end of the year (abut 0.5-0.6% of GDP annually). However, fiscal trends detected in Q1 and Q2, and the expected macroeconomic trends by the end of 2013 (inflation slowdown, quite stable dinar exchange rate, no significant change in the dynamics of economic activity and income) suggest that the public revenues (primarily from contributions) projected in the budget rebalance might be below the target. The same goes for certain savings that have been projected in the budget rebalance. On the basis of the trends detected in Q1 and Q2, and macroeconomic and fiscal projections for the rest of the year, and without implementation of additional measures, 2013 fiscal deficit to GDP is projected at 5.5-6% (according to domestic methodology).

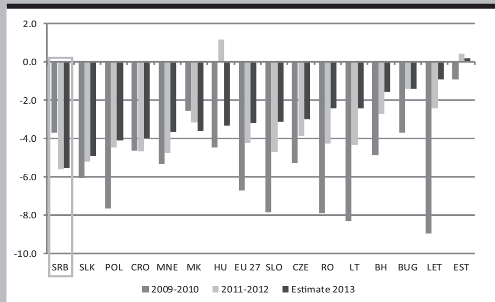
...or 7-7.5% of GDP, according to international methodology

Expenditures on financial rehabilitation of banks, expenditures on principal repayment of government guaranteed public enterprise debt etc., totalling about 1.5% of GDP, are not recognized as expenditures in the Law on the Budget, although international (GFS) methodology recognizes them as budget expenditures. If these expenses were treated as budget expenditures, total consolidated fiscal deficit in 2013 could run at extremely large 7-7.5% of GDP.

Box 1. Fiscal performance of Central and East European states (2008-2013)

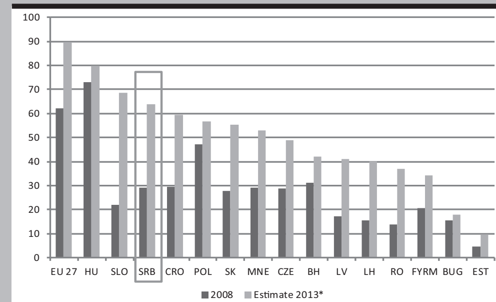
At the beginning of the world economic crisis Serbia ran fiscal deficit at 2% of GDP (in 2008), which was much smaller than in most Central and East European Countries (CEE). During the first two years of the crisis (2009 and 2010) Serbia's fiscal deficit widened due to the crisis and the discretion measures adopted at the beginning of the crisis (extraordinary increase in pensions in 2008), but it was still around the average in CEE states (nominal salary and pension freeze in 2009-2010 prevented its larger rise). However, while almost all CEE countries managed to cut their fiscal deficits considerably in 2011 and 2012, Serbia's fiscal deficit continued to rise during this period, and was the largest among the analyzed countries. Projections for 2013 are similar – almost all CEE states will continue cutting their fiscal deficit, and fiscal deficit in Serbia will be somewhat smaller than in 2012. In 2013 Serbia will run the largest fiscal deficit among all CEE states (according to both domestic and international methodology).

Graph T6-4. Serbia and Central and East European states: Consolidated fiscal deficit, % BDP (2008-2013)



Source: IMF, Eurostat and Public Finance in EMU, 2013

Graph T6-5. Serbia and Central and East European states: Public debt, % GDP (2008-2013)



Source: IMF, Eurostat and Public Finance in EMU, 2013

Consequently, from a country with a moderate public debt level in 2008, around the average in CEE states, in 2013 Serbia became a country with the third highest public debt (% GDP) in CEE, after Hungary and Slovenia. From 2009 to 2013 Serbia experienced the second largest relative increase in public debt in CEE countries (after Slovenia).

The foregoing data show that most CEE countries managed to achieve a moderate or considerable fiscal deficit reduction, and that Serbia's fiscal deficit is still high and growing. This indicates that the probability of debt crisis in Serbia is much higher than in other CEE countries, so the measures aimed at substantial reduction in fiscal deficit as early as in 2014 must be adopted already in 2013.

Major fiscal adjustments, not only through curbing shadow economy, but also through additional savings of 1-1.5% of GDP, are required in 2014

Slowdown in public debt growth and its reduction require a massive cut in fiscal deficit as early as in 2014. As announced, fiscal deficit is targeted at around 4% of GDP in 2014, though it is not clear whether the projection was based on international methodology or the methodology envisaged in the Law on the Budget. If domestic methodology was employed, fiscal deficit targeted at 3.5-4% of GDP would be more appropriate, i.e. it would be reduced by 2-2.5% of GDP compared with 2013. If international methodology was used, fiscal deficit reduction could be larger (3-3.5% of GDP), and the fiscal deficit could be targeted at 3.5-4% of GDP. Larger reduction in fiscal deficit according to international methodology implies that expenditures on payment of guaranteed loans would be cut, and that no further expenditures would arise from the financial rehabilitation of banks in the following year.

Box 2. Tackling shadow economy – possible fiscal effects

As announced, fight against shadow economy will be one of the key instruments for fiscal consolidation in the following period. Shadow economy rate in Serbia is among the highest in the region (with the rate of about 31% of GDP Serbia is ranked second, after Bulgaria), so a fight against it is necessary, both from the aspect of fiscal consolidation and fair market competition.

Empirical studies show that even if all recommended measures against shadow economy were effectively implemented, rise in public revenues would not exceed 1% of GDP in the mid-term (the following 2-3 years), and it would probably be even smaller in the following year (about 0.5% of GDP).[1] Accordingly, further implementation of stringent policy on tax evasion is critical for bringing

1 More detailed analysis of the causes, mechanisams and effects of shadow economy, and possible measures against it is presented in the study, Krstić, G., et. al. (2013) „ Shadow economy in Serbia – new findings and recommended reforms ", FREN and USAID; Belgrade, 2013

order in tax system and increase in revenues. Quality of service delivered by the inspection bodies (primarily the Tax Administration and Labor Inspection) must be improved in order to identify informal business activities more efficiently, and thus produce the foregoing fiscal effects. Reform in the penalty system for tax evasion (regarding the amount and structure) should be considered. However, a more efficient tax collection also requires implementation of measures designed to tighten overall financial discipline in Serbia (more efficient bankruptcy proceedings etc.), and measures intended to increase labor market flexibility.

Lag effect of the measures adopted mid 2013 (restrictive salary and pension indexation) will be reduction in fiscal deficit by about 1% of GDP in 2014. On the other hand, rise in public debt and tougher loan conditions are expected to increase expenditures on interest payments by about 0.4% of GDP[1], which will take up almost a half of the projected savings from reduction in expenditures on salaries and pensions. Effective implementation of strategic measures intended to curb shadow economy could reduce fiscal deficit by about 0.5% of GDP. The targeted 2-2.5% of GDP reduction in fiscal deficit in 2014 can thus be achieved only through additional savings of about 1-1.5% of GDP. If great problems arose in the banking sector, requiring government's intervention, reduction in other current expenditures would have to be even larger in 2014. Accordingly, structural reforms in public enterprises, pension system, education, health insurance, public administration etc. aimed at reduction in expenditures (in 2014 and the succeeding years) and improved efficiency and quality of service in these fields, must be undertaken as early as in 2013. Additionally, greater coordination between the Government and the National Bank of Serbia regarding control and management of the risks involved in banking sector is necessary due to a possibility that the government's intervention in banking sector may be needed in the next year, which would considerably increase budget expenditures.

Numerous studies and strategies, based on contemporary methodology and good comparative practices, providing strategic framework for implementation of structural reforms (tax reforms, curbing shadow economy, labor market reforms, reforms in education and healthcare system etc.) were made in the previous years in Serbia, as well as a number of practical measures that should be taken accordingly. These studies and strategies are a solid base for planning and introduction of the needed reforms, so the government should not spend more time and resources on reanalyzing and redesigning them, but should focus on their implementation.

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

Public revenues in Q2 still much lower than in the same period last year, but showing signs of a modest recovery

Public revenues continued to fall in Q2 2013 compared with the same period last year (by 3.2%). Although real seasonally adjusted public revenues went up in Q2 relative to Q1 (by 3.3%), this rise is not a sign of lasting recovery, but mainly a consequence of specific and one-off factors. These factors are: continuation of a modest recovery in economic activity, slight real depreciation of the dinar exchange rate, and time allocation of revenues (for example revenues from VAT) from Q1 to Q2 due to the new tax collection system.

Revenues from VAT are much lower than in the same period last year, but much higher than in Q1 2013 – a consequence of one-off factors

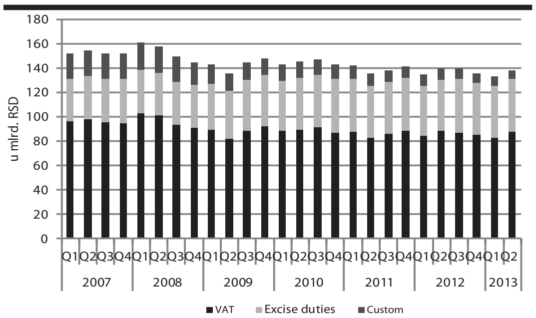
Real revenues from VAT in Q2 went down slightly (by 0.6%) compared with the same period last year, but relative to Q1 2013 real seasonally adjusted VAT revenues went up (by 6%). Revenues from VAT fell because a switch from domestic demand to exports was made in national economy (see Chapter 2 on economic activity). Economic restructuring is favorable from the aspect of macroeconomy, but it has negative impact on tax collection. Restructuring of national economy will probably continue in the future, because growth in domestic demand is slower than GDP growth[2]. Another cause of lower revenues from VAT is strong real appreciation of the

1 See the Fiscal Council analysis and estimates.

2 In several issues of QM, in the previous years, we wrote that decrease in domestic demand and rise in exports would cause drop in revenues from VAT. Since this process was inevitable (otherwise, balance of payment crisis would arise), the drop in revenues from VAT was predictable.

dinar exchange rate in the first half of 2013 compared with the same period last year – this effect is very important since about 2/3 of VAT is collected from imports. Economic policy-makers should bear in mind that large drops in inflation and appreciation of the dinar exchange rate reduce tax revenues, so fiscal deficit can be reduced only through cuts in nominal expenditures. This is an important change in Serbia because in the past fiscal consolidation was often achieved through high inflation which brought in high tax revenues but reduced the value of real expenditures. Revenues from VAT in Q2 went up relative to Q1 due to changed administration and collection of VAT, slight real depreciation of the dinar exchange rate in Q2 and a modest growth in economic activity. Administration and collection of VAT has been changed considerably from January, so most VAT payments were postponed from March to April. Modest growth in domestic demand in Q2 (see the chapter on economic activity) exerted positive effects on revenues from VAT in this quarter. Although the Tax Administration announced strong actions on identifying and sanctioning tax evasion (inspection of fiscal receipt issuance was announced), higher level of tax collection produced modest effects on overall tax revenues, including revenues from VAT in Q2. Nevertheless, growth in revenues from VAT continued in July (real seasonally adjusted revenues went up by 1.1% compared with Jun), which suggests that the Tax Administration's efforts to increase the level of tax collection might have paid off in July, though a more precise estimation requires the data on the following few months.

Graph T 6-6. Serbia: Trends in real consolidated seasonally adjusted revenues from consumption tax (in 2012 prices)



Source: *QM* calculations

Excise revenues went up considerably

Real seasonally adjusted excise revenues in Q2 2013 went up both relative to Q1 and the same period 2012 (by 2.1% and 20.1% respectively). Excise revenues in this quarter were higher than in the same period last year due to increase in excise. The growth in excise revenues in Q2 relative to Q1 is caused by slight real depreciation of the dinar to euro exchange rate, earlier than usual payment of some excise duties, but can also indicate that illegal sale of some excise goods (shredded tobacco etc.) has been curbed.

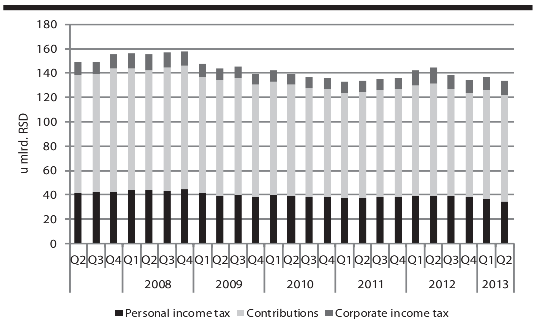
...while customs revenues keep dropping

Customs revenues (real, seasonally adjusted) dropped considerably (by 6.1%) in Q2 relative to Q1, which is a continuation of the trend detected in the previous years. This drop is due to further reduction in tariffs on goods imported from EU (additional reduction according to the Stabilization and Association Agreement was made in February 2013 and comprised last two months of Q1 and the whole Q2 2013). This drop in customs revenues would have been even larger if there had not been for a slight depreciation of the dinar exchange rate in Q2 and continuation of the upwards trend in production in car and petroleum industry, wherein a great portion of raw materials and other inputs is imported.

...as well as revenues from personal income tax and social security contributions, due to reduction in real income

Revenues from personal income tax (real seasonally adjusted) fell considerably in Q2 (by 6.8%) relative to Q1, and revenues from social security contributions went down slightly (by 1%). Compared with the same period 2012, real revenues from personal income tax dropped significantly (by 12.3%), and revenues from social security contributions fell less sharply (by 4.4%). Revenues from personal income tax and social security contributions in Q2 were affected by further real drop in income, reformed wage taxation system, and possibly by further rise in informal employment. The dynamics of revenues from personal income tax and social security contributions is primarily caused by reforms in wage taxation system. Reduction in tax rate for wages by 2 percentage points, and increase in non-taxable part of wage, starting from 1 June 2013, decreased revenues from personal income tax considerably. On the other hand, although the contribution rate for pension and disability insurance was increased by 2 percentage points starting from June 2013, revenues from social contributions in Q2 went down relative to Q1. This is due to further drop in real income (Real public-sector wage bill, taking up almost a half of the total wage bill

Graph T 6-7. Serbia: Trends in real consolidated seasonally adjusted revenues from taxes on factors of production (in 2012 prices)



Source: *QM* calculations

in Serbia, was reduced by 2.9% in Q2 relative to Q1. Similar trends were detected in private sector). Such trends in revenues from personal income tax and social security contributions also suggest that the Tax Administration's announced activities towards more efficient collection of taxes and social security contributions failed to produce detectible effects.

Revenues from corporate income tax in Q2 much lower than in 2012

Real seasonally adjusted revenues from corporate income tax in Q2 2013 are lower than in the same period last year by 7.9%, but relative to Q1 2013 they went up by 5.4%. These revenues dropped relative to the previous year primarily because the level of economic activity fell and financial performance of Serbian economy in 2012 was poor. Revenues from corporate income tax in Q2, when the final tax liability for 2012 is paid, possibly went up due to use of accruals and deferrals to boost the profit declared in 2012, taxable at the rate of 10%, and lower the profit in 2013, taxable at the rate of 15%. Additionally, maturity of interest and dividend payments from Serbian companies to foreign creditors and investors might have increased revenues from withholding tax on these payments. Since most sections of economy suffer from recession, increase in operating profitability cannot be expected. However, real appreciation of the dinar exchange rate will mainly bring accrued gains, rather than real foreign exchange rate gains, which will considerably increase the overall profit in 2013 – if the appreciated exchange rate remains unchanged by the end of the year.

Other tax revenues (real seasonally adjusted) went up slightly in Q2 (by 2.6%) relative to Q1. This could be due to local communities' increased efforts towards collection of local public revenues, by expanding the scope of property taxation and by exploiting legal possibilities for property taxation more fully, since they lost a part of revenues from wage tax and other quasi-fiscal charges. Non-tax revenues (real seasonally adjusted) went up considerably (by 13.5%) in Q2 relative to Q1, because the government collected some outstanding debts, and because non-tax revenues fell sharply in Q1.

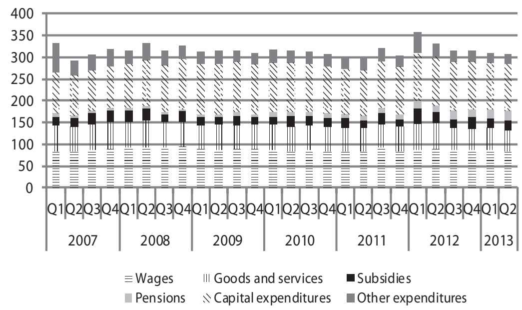
Public expenditures in Q2 fell steeply relative to the same period last year, but when compared with non-election years and Q1 2013, they slightly went up

Public expenditures in Q2 fell by 6.6% relative to the same period last year, but when compared with Q1 this year, real seasonally adjusted public expenditures went up. They are lower than the last year's because: 1) public expenditures in Q2 2012 were extremely high due to high election spending (elections were held in May 2012) and 2) modest nominal rise in most public expenditures was projected in 2013 Budget, but with high y-o-y inflation rate real expenditures went down considerably (see chapter 5). Real public expenditures in Q2 will be occasionally benchmarked against the data for 2011 because the level of public expenditures in 2012 is not usual due to high election spending. So, real public expenditures in Q2 2013 went up (by 1.9%) relative to Q2 2011, and similar rise in expenditures (by 1.1%) was recorded relative to Q1 2013. Overall public expenditures in Q2 slightly went up relative to Q1 due to a sharp increase in expenditures on interest payments and modest increase in expenditures on pensions, while all other public expenditures went down.

…due to a strong rise in expenditures on interest payments…

Q2 saw a strong rise in real seasonally adjusted expenditures on interest payments (27.1%) relative to Q1, and when compared with the same quarter 2012 the rise is even stronger (86.3%). Expenditures on interest payments went up due to increase in public debt and country risk, and one-off factors. Accordingly, interest payments on debt to Paris and London Club creditors and semi-annual coupons on euro-denominated bonds issued in November 2012 fell due in April 2013, which caused the rise in expenditures on interest payments in Q2. Another cause of the rise in expenditures on interest payments (projected at about 0.4% of GDP annually) is the increase in Serbia's public debt. Rise in expenditures on interest payments was also caused by a slight real depreciation of the dinar exchange rate in Q2, and tougher borrowing conditions

Graph T 6-8. Serbia: Trends in consolidated seasonally adjusted public expenditures (in 2012 prices)



Source: *QM* calculations

(indicated by the increase in EMBI index and the rate of yield on euro-denominated bonds of the Republic of Serbia).

…and a small rise in expenditures on pensions…

Expenditures on pensions (real seasonally adjusted) in Q2 went up slightly (by 0.8%) relative to Q1, but when compared with Q2 2012, a modest real drop (by 4.1%) is detected. Expenditures on pensions in Q2 were higher than in Q1 due to regular indexation of pensions by 2% in April. Real expenditures on pensions are expected to go down slightly because the rate of the next indexation, in October, will be lower (0.5%), and reduction in these expenditures is one of the key instruments for curbing fiscal deficit. A noticeable rise in expenditures on pensions in Q2 2013 relative to the same period 2011 is due to increase in numbers of pensioners (due to population aging), one-off aid to pensioners, and the pension indexation.

…while all other public expenditures go down moderately

Q2 saw a moderate reduction in real seasonally adjusted expenditures on employees relative to Q1 2013 and to Q2 2012 (by 2.9% and 5.7% respectively). Announced slower wage indexation in October 2013 and in the next year will cause a slight reduction in expenditures on employees in real (and relative) terms. However, massive cuts in these expenditures, necessary for substantial reduction in fiscal deficit, can be made only through implementation of strategic measures aimed at public sector employee right sizing (primarily in education and health care system and public administration) and reform in the public sector wage system.

Real seasonally adjusted expenditures on goods and services in Q2 fell moderately relative to Q1 (by 3.9%), and expenditures on subsidies went down considerably (by 7.5%). Expenditures on goods and services went down partly due to reduction in some discretionary expenditures, which is considered reasonable as long as delivery of public services is not jeopardized. However, savings from cuts in discretionary expenditures are limited and temporary, so certain strategic savings from reduction in expenditures on goods and services can be made only through a more efficient system of public procurement and procurement prioritization. Trends in expenditures on goods and services detected in Q2 confirm QM and the Fiscal Council's forecasts that enforcement of the new Law on Public Procurements will bring in savings much below EUR 600 million per year.

Slowdown in expenditures on subsidies was caused by reduction in subsidies on investments and employment and to some public enterprises. Cut in expenditures on subsidies is one of the Government's key instruments for achieving fiscal consolidation in 2013, which is considered economically reasonable, but requires simultaneous implementation of reforms aimed at economic consolidation in public sector and improved business environment.

Capital expenditures (real, seasonally adjusted) in Q2 continued to fall moderately (by 4.2%), because some projects were put off due to a slowdown in government revenues. Real capital expenditures went down by as much as 30.2% relative to Q2 2012. Capital expenditures in Q2 2012 ran at 1.8% of the quarterly GDP, which is much below the quarterly fiscal deficit. This indicates further deterioration in the net asset position of Serbia in Q2, because current expenditures take up almost 2/3 of the fiscal deficit, meaning that the future generations will have to shoulder the burden of the current expenditures. Since capital expenditures stimulate economic growth more greatly than any other type of public expenditures, and the basic infrastructure in the country is undeveloped, increase in these expenditures, followed by massive reduction in current expenditures, would be economically reasonable in the following period. However, financial decisions should be prioritized more efficient to produce the maximum output out of limited resources.

Fiscal trends by government levels

Local government revenues suffered the largest drop due to wage tax reduction and quasi-fiscal charges reform

Although real revenues on all government levels went down in Q2 2013 (relative to the same period last year), local governments suffered the largest drop due to reduction in tax rate for wages from 12% to 10% and increase in non-taxable part of wage, as of June, and quasi-fiscal charges reform in Q3 2012 (see Appendix 3)[3]. Reduction in tax rate for wages took effects only in one month of Q2, so local governments can expect further fall in these revenues in the future. Reduction in tax rate for wages has *de facto* cushioned the negative effects of fiscal decentralization carried out in 2011. Additionally, other local tax revenues fell due to the reform in quasi-fiscal charges. Since this reform was carried out in Q3 2012, the data show that its effects on local revenues have worn off (Q2 saw a real rise in these revenues relative to Q1 this year). The drop in local revenues is substantial so local communities will probably increase their efforts towards a more effective exploitation of property tax, as an instrument for local revenue collection, primarily through expanding the scope of property taxation and enhanced tax collection system. However, reforms in wage taxation and quasi-fiscal charges will probably widen local government fiscal deficit in 2013, and even jeopardize functioning of some local municipalities, because the liabilities taken on at the beginning of 2013 were proportional to the projected budget revenues, which will probably fall short of the plan.

... so did the local government expenditures

Reduction in public revenues caused reduction in public expenditures on all government levels in Q2, and the largest cut was made on the local level due to fall in local government revenues. Distribution of some local revenues to the central budget is considered economically reasonable incentive to local governments to cut their expenditures. However, the largest reductions were made in capital expenditures (real drop of 40.4% in Q2 relative to the same period last year), while the cuts in less productive expenditures (expenditures on employees etc.) were much smaller, which is considered unfavorable. This is in line with QM forecasts about the 2011 fiscal decentralization measures that the local governments would use additional funds primarily to increase current expenditures, rather than to invest, and that it will cause rise in local government current expenditures, which will be difficult to reduce afterwards. Accordingly, closer control of the purpose of local government revenue spending, through conditioning redistribution of funds from the central level by full exploitation of property taxation and other local government revenues and the dynamics of local government expenditures on wages in line with the dynamics of these expenditures on the central level, is recommended.

Analysis of trends in public debt

Public debt in Serbia amounted to EUR 19.08 billion (60,5% of GDP)

According to the official data released by the Ministry of Finance and Economy, at the end of July 2013 Serbia ran up public debt of EUR 19.8 billion (around 60,5% GDP[4]), EUR 310 million lower than in Q1. When compared with the same period last year, public debt went up by EUR 3.6 billion, or by 4.6% of GDP.[5] This rapid growth in public debt in the previous 12 months is caused by large fiscal deficit in the second half of 2012 and the first half of 2013, government guaranteed loans to public enterprises and financial rehabilitation of banks. Public debt during the new Government's first few months in power went up considerably because the liabilities inherited from their predecessors had to be covered. In the period April-July 2013 public debt went down because accumulated funds were used to finance fiscal deficit and for principal repayment of loans that fell due in this period.

Decrease in public debt in the period April-July was short-lived

Public debt in the period April-July went down because funds collected through issuance of euro-denominated bonds and other borrowing in the previous months were used to cover fiscal

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

4 *QM* estimate is based on comperison between the nominal public debt and the sum of GDP in Q2 2013 and the previous three quarters (which is in line with the international methodology), and the Ministry of Finance and Econoy estimate is based on comparison between nominal public debt and the projected GDP for 2013, which is incorrect from the aspect of economics, and is not in line with international methodology.

5 The amount of EUR 3.6 billion approximately equals 12% of GDP. However, relative increase in public debt (in Q2 2013 relative to Q2 2012) was much lower due to a strong appreciation of the dinar-euro exchange rate in that period (more than 10%).

deficit and principal payments on loans and cannot be perceived as a sign of recovery in public finance or the beginning of a downwards trend in public debt. Since a considerable portion of the funds collected through issuance of euro-denominated bonds has already been spent in the previous quarters, the government will have to provide for additional funds in the following period (either through issuance of euro-denominated bonds or through direct borrowing from financial institutions or other countries) to cover fiscal deficit and liabilities in the following quarters. Additional borrowing will cause detectible rise in public debt, in nominal and relative terms, as a % GDP.

Because fiscal deficit is made up through borrowing (revenues from privatization are low and a long-term growth in these revenues is not expected in the following period), the relationship between fiscal deficit and public debt is strong. To slow down and then to curb public debt, the government must reduce fiscal deficit, put limits on issuance of government guarantees and minimize the risks stemming from the problems in banking sector.

Table T6-9. Serbia: Public debt[1] 2000-2013

	Amount at the end of period, in billions EUR											
	2000	2005	2006	2007	2008	2009	2010	2011	2012	Q1 2013	Q2 2013	July 2013
I. Total direct debt	14.17	9.62	8.58	8.03	7.85	8.46	10.46	12.36	15.07	16.61	16.05	16.22
Domestic debt	4.11	4.26	3.84	3.41	3.16	4.05	4.57	5.12	6.45	6.67	6.54	6.54
Foreign debt	10.06	5.36	4.75	4.62	4.69	4.41	5.89	7.24	8.62	9.94	9.51	9.68
II. Indirect debt	-	0.66	0.80	0.85	0.93	1.39	1.71	2.11	2.60	2.78	2.85	2.85
III. Total debt (I+II)	**14.17**	**10.28**	**9.38**	**8.88**	**8.78**	**9.85**	**12.17**	**14.47**	**17.67**	**19.39**	**18.90**	**19.08**
Public debt / GDP[2]	**169.3%**	**50.2%**	**36.2%**	**29.4%**	**25.6%**	**31.3%**	**41.5%**	**45.07%**		**57.70%**	**57.4%**	**57.7%**
Public debt / GDP (QM)[3]	**169.3%**	**52.1%**	**37.8%**	**30.9%**	**29.2%**	**34.8%**	**44.6%**	**46.9%**	**61.4%**	**62.2%**	**60.2%**	**60.5%**

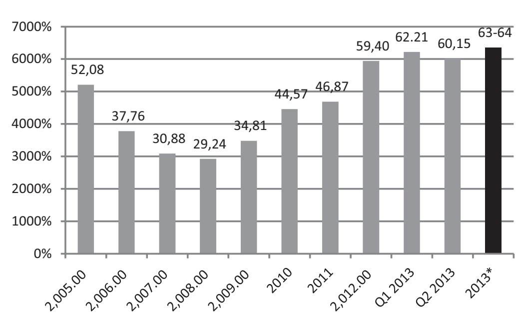
Source: Ministry of Finance and Economy data and *QM* estimate

Growth in indirect debt continues as of April, and direct debt goes down temporarily

The overall public debt went down in the period April-July due to decrease in the direct debt (by EUR 390 million) and further increase in indirect debt (by EUR 80 million). Although the growth in indirect (guaranteed) public debt slowed down in the period April-July, the average growth was EUR 20 million per month relative to EUR 50 million per month in the previous quarters, it is still considered quite high because if this trend continues, annual growth in public debt will run at around 1% of GDP. The Government therefore must obey the limitations on issuance of government guarantees, set in 2013, and the maximum annual government guarantee threshold should be set (for example 0.5% of GDP). The agreement on strategic partnership between the JAT Airways and Etihad Airways that should provide for successful future operating of the national airline without direct or indirect government subsidies is a step in the right direction. According to this agreement the government has to make large investments (purchase of airplanes), which will be funded through additional borrowing, so this type of partnership is not desirable in case of other public enterprises because it would lead to further increase in public debt. Therefore, the government should not make heavy commitments when resolving the problems in public enterprises. Besides, government borrowing to invest in sectors that can be privatized, such as electricity sector, is unreasonable.

Chances that the expensive loans will be replaced by the cheap ones are still slim

Graph T 6-10: Serbia - trends in public debt (% GDP)



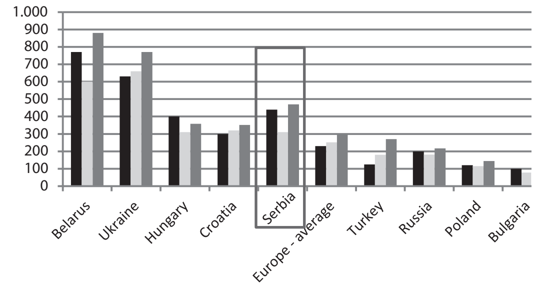
Source: *QM* calculations

One of the announced measures aimed at more efficient public finance management after the reconstruction of Serbian Government is replacement of the existing expensive loans with new loans offering better terms. However, we believe that this is quite unlikely because the situation in the international financial market has worsened and the state of Serbian public finance is unfavorable (large fiscal deficit and public debt). Speaking from experience, it is quiet unlikely to achieve this through some non-commercial interstate arrangement, as well. We believe that a comprehensive debt rescheduling program would be possible under the patronage of IMF, preceded by strong fiscal consolidation and arrangement with IMF. However, this would be reasonable just in case of emergency, because implicit declaration of bankruptcy goes without saying with this program. Serbia should therefore improve its fiscal position and reduce risk premiums, and then replace expensive loans with loans offering better terms, and short-term loans with long-term loans.

Risk premiums on the Government Bonds of the Republic of Serbia go up due to unfavorable fiscal trends

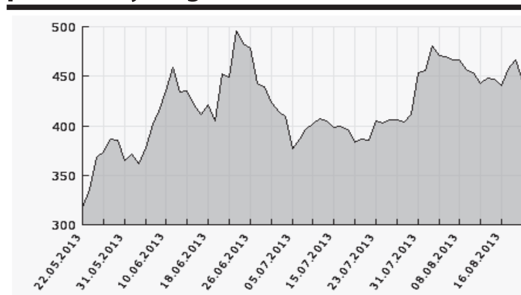
In the period April-August 2013 yield/risk on the Government Bonds of the Republic of Serbia, measured by *Emerging Markets Bond Index* (EMBI), increased from 310 basis points (at the beginning of May) to more than 470 basis points (in August). Although EMBI went up in all other Central and East European countries (on average by 25%), increase in EMBI for Serbia was among the largest in relative terms (about 52%). The rise in risk/yield on government bonds is mainly assigned to negative fiscal trends and the absence of a comprehensive fiscal consolidation program, and to a certain extent to general trends in the global market.

Graph T6-11. Serbia and the selected Central and East European countries: EMBI



Source: web page www.cbonds.info

Graph T6-12. Serbia: Trends in MBI in the period May-August 2013



Source: web page www.cbonds.info

If macroeconomic and fiscal flows remain unchanged, public debt at the end of 2013 will amount to 63-64% of GDP

With fiscal deficit at about 5.5-6% of GDP in 2013, and without further advance borrowing, and with other macroeconomic variables in line with official projections (2% growth in real GDP, average inflation rate in 2013 relative to 2012 at about 10%, y-o-y inflation rate at the end of the year at 5-6%), with steady real dinar-euro exchange rate, and with unchanged dynamics of the indirect public debt, Serbia's public debt at the end of 2013 could amount to about 63-64% of GDP. Deviation of any of these variables from the projected values would cause the deviation of the level of public debt. Public debt could exceed the projections due to: *i)* the risk of a larger fluctuation in the dinar exchange rate at the end of the year, *ii)* risk that the government's intervention in banking sector may be needed again, *iii)* risk of further deterioration in fiscal flows caused by inadequate implementation of the plan envisaged in the Budget Rebalance, *iv)* risk of increase in government guarantees on loans granted to some public enterprise, *v)* government's decision to significantly increase the level of advance borrowing to cover 2014 fiscal deficit. Exchange rate risk management is quite limited in the short term. However, other foregoing risks can be managed, so the government should monitor them systematically in the following period and adopt measures that can be taken aginst these risks soon after they arise.

Appendices

Appendix 1. 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	Q1 - Q2	Q2 2013-Q2 2011
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**	**-4.5**	**1.3**
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	-4.6	1.3
Tax revenue	3.7	-8.8	-2.5	-4.1	1.9	5.3	1.9	-4.4	1.0	-4.2	-2.1	-3.1	3.0
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	-8.9	-8.4
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	-21.5	28.7
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	-1.4	6.1
Excises	0.7	11.6	4.2	0.6	-5.7	-3.0	8.5	-7.0	-1.2	9.5	20.1	15.2	16.4
Custom duties	1.8	-32.4	-14.9	-21.5	-18.6	-8.6	-11.4	-17.6	-14.0	-15.3	-20.5	-18.1	-27.4
Social contributions	4.3	-7.0	-6.5	-3.9	4.8	6.1	0.7	-3.4	1.9	-3.0	-4.4	-3.7	1.3
Other taxes	-2.3	-4.9	14.5	-15.2	-9.7	7.6	-12.0	-19.2	-8.8	-14.2	-15.6	-15.0	-9.4
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	-15.4	-10.5
2. Capital revenues	-76.8	-41.4	-66.8	468.2	124.1	259.1	176.7	373.3	304.5	159.3	-63.5	11.0	30.9
II TOTAL EXPENDITURE	**4.5**	**-4.8**	**-1.7**	**3.3**	**10.3**	**9.2**	**-2.9**	**1.5**	**4.3**	**-10.5**	**-6.6**	**-8.5**	**1.9**
1. Current expenditures	6.9	-3.3	-2.2	3.1	8.2	9.3	-1.7	1.4	4.1	-7.3	-5.1	-6.2	3.5
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	-4.0	0.1
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	-17.2	-8.4
Interest payment	-2.8	-5.7	-0.3	17.4	48.1	6.6	93.4	23.4	41.9	9.8	86.3	45.2	98.3
Subsidies	-13.3	19.0	40.6	7.4	42.6	56.4	-36.2	82.9	29.1	-24.6	-20.6	-22.6	24.0
Social transfers	10.1	-26.0	13.9	5.8	3.8	2.9	-0.3	-6.1	-0.1	-6.4	-2.6	-4.4	0.1
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*	*-4.5*	*2.8*
Other current expenditures	14.9	6.7	-6.1	23.9	-17.1	36.8	12.2	11.8	9.9	-24.1	-26.5	-25.6	0.4
2. Capital expenditures	-4.3	-6.7	-11.8	5.3	48.7	8.3	-14.9	2.3	6.0	-53.6	-30.2	-42.7	-24.5
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**	**-41.9**	**-37.6**	**-39.6**	
IV TOTAL EXPENDITURE, GFS (II+III)	**4.6**	**-4.8**	**-1.1**	**-3.8**	**9.8**	**7.7**	**-3.5**	**1.2**	**3.6**	**-10.9**	**-7.0**	**-8.9**	

Source: Table P-10 in Analytical Appendix.
1) See footnote 1) in Table T7-1.
2) Retail sales tax/VAT minus new tax credits to enterprises.
3) Social contributions reduced by refunds between Pension Fund, Serbian Development Fund and enterprises that are debtors of the Pension Fund.
4) QM's estimate, for details see Table P-10 in Analytical appendix.
5) Refers to the current expenditures on pensions.
Note: Real growth is obtained comparing 2003 constant prices quarterly data
Realni rast dobijen je primenom prosečnog baznog indeksa cena na malo (baza decembar 2003) na kvartalne podatke.

Appendix 2. Serbia: Consolidated General Government Fiscal Operations[1)], 2008-2013 (nominal amounts)

	2008	2009	2010	2011	2012					2013		
					Q1	Q2	Q3	Q4	Q1-Q4	Q1	Q2	Q1-Q2
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**	**692.4**
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	688.6
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	618.1
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	78.0
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	29.4
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	186.1
Excises	110.1	134.8	152.2	170.9	34.6	40.6	54.9	51.0	181.1	42.5	53.7	96.2
Custom duties	64.8	48.0	44.3	38.8	7.7	9.0	9.3	9.8	35.8	7.3	7.9	15.2
Social contributions	312.7	318.8	323.0	346.6	85.9	94.6	94.5	103.9	378.9	93.4	99.7	193.0
Other taxes	35.6	37.1	46.0	43.5	9.7	11.7	10.8	10.4	42.6	9.3	10.9	20.2
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	70.5
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	2.4
	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**	**-363.7**	**-402.7**	**-766.4**
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	-350.5	-385.4	-735.9
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	-191.9
Expenditure on goods and services	-181.2	-187.4	-202.5	-216.3	-51.2	-62.9	-53.8	-67.7	-235.7	-49.6	-55.3	-104.9
Interest payment	-17.2	-187.4	-34.2	-44.8	-15.4	-13.4	-23.3	-16.2	-68.2	-18.9	-27.5	-46.4
Subsidies	-77.8	-22.4	-77.9	-80.5	-22.6	-25.2	-19.6	-44.2	-111.5	-19.0	-22.0	-41.1
Social transfers	-496.8	-63.1	-579.2	-609.0	-154.9	-161.1	-163.5	-173.0	-652.5	-162.4	-173.0	-335.4
o/w: pensions[5)]	*-331.0*	-556.4	*-394.0*	*-422.8*	*-112.5*	*-117.8*	*-119.2*	-124.1	-473.7	-119.9	-124.5	-244.4
Other current expenditures	-23.5	-387.3	-22.9	-31.7	-7.9	-11.7	-8.0	-9.8	-37.4	-6.7	-9.5	-16.2
2. Capital expenditures	-106.0	-24.0	-105.1	-111.1	-25.3	-22.5	-30.0	-48.6	-126.3	-13.2	-17.3	-30.4
III "OLD" DEBT REPAYMENT, GOVERNMENT NET LENDING AND RECAPITALIZATIONS	**-19.1**	**-20**	**-29.9**	**-24.9**	**-4.7**	**-5.7**	**-2.3**	**-3.9**	**-16.6**	**-3.1**	**-3.9**	**-6.9**
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**	**-366.7**	**-406.6**	**-773.3**

Source: Table P-10 in Analytical Appendix.
1) See footnote 1) in Table T7-1.
2) Retail sales tax/VAT minus new tax credits to enterprises.
3) Social contributions reduced by refunds between Pension Fund, Serbian Development Fund and enterprises that are debtors of the Pension Fund.
4) QM's estimate, for details see Table P-10 in Analytical appendix.
5) Refers to the current expenditures on pensions.
Note: Real growth is obtained comparing 2003 constant prices quarterly data
Realni rast dobijen je primenom prosečnog baznog indeksa cena na malo (baza decembar 2003) na kvartalne podatke.

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

	Q2 2013/Q2 2012			
	Consolidated budget	Budget of Republic	Health Fund	Local self-governments
A Total public revenues (I)+(II)	**-3.2**	**-0.3**	**-4.3**	**-15.0**
I Current revenues (1)+(2)	-2.9	0.1	-5.2	-15.1
1. Tax revenues	-2.1	2.3	-6.4	-15.8
1.1. Customs	-20.5	-20.6	-	-
1.2. Personal income tax	-12.3	-9.6	-	-13.7
1.3. Corporate income tax	-7.9	-10.9	-	-
1.4. VAT	-0.6	-0.8	-	-
1.5. Excise duties	20.1	20.0	-	-
1.6. Property taxes	-9.9	-	-	-9.9
1.9.Other taxes	-15.6	13.7	-	-40.3
1.10. Social security contributions	-4.4	0.0	-6.4	-
2. Non-tax revenues	-9.4	-16.5	142.6	-12.9
II Capital revenues	-63.5	-	11.6	12.4
III Transfers from the other levels of government	-	-	-2.2	-16.9
IV Donations	-33.5	-61.7	-	88.2
B Total public expenditures (I)+(II)+(III)	**-6.6**	**-5.2**	**-7.0**	**-15.2**
I Current expenditures	-5.1	-4.6	-7.1	-9.7
1.1 Wages	-5.7	-5.3	-7.8	-3.4
1.2. Goods and services	-20.3	-38.1	-5.9	-15.5
1.3 Interest payments	86.3	94.3	60.8	-7.1
1.4 Subsidies	-20.6	-27.0	-	-12.9
1.5 Social insurance and social assistance	-6.4	15.3	-10.5	-4.4
1.6 Transfers to the other levels of government	-	-7.4	-	-
1.7 Other current expenditures	-24.1	-41.4	59.3	-14.2
II Capital expenditures	-53.6	-6.6	98.9	-40.4
IV Net lending	-41.9	-30.3	-	293.7

Source: *QM* calculations