

## 6. Fiscal Trends and Policy

In Q2 2012, the consolidated fiscal deficit stood at 56.1 billion Dinars (about 6.7% of the quarterly GDP). The consolidated fiscal deficit at the level of the first half of the year stood at 110 billion Dinars (about 6.9% of the half year GDP). The deviation from the planned deficit is primarily the consequence of the strong growth of public spending compared to the planned amount and dynamics as well as the fact that in 2012 there will be a slight drop in economic activity instead of the slight rise which has a negative effect on trends in public revenues. Considering that months after the elections a plan of fiscal consolidation has not been adopted and implemented, if the macroeconomic and fiscal trends continue from the first half of the year, the estimate is that the consolidated fiscal deficit in 2012 will stand at about 6.5% of the GDP. As a consequence of the high fiscal deficit in Q2 and the intervention of the state to stabilize the banking sector, the public debt at the end of that quarter stood at about 54.9% of the GDP (at the end of July – 56.3% GDP). If the existing trends continue, the assessment is that the public debt will stand at around 60% GDP by the end of 2012. Without a quick implementation of a credible plan for fiscal consolidation there is a high degree of risk of a debtor crisis in a relatively short period. Even if certain measures of fiscal consolidation are implemented in the final quarter of 2012, it will not be possible to achieve a significant lowering of the fiscal deficit in the current year. However, with an appropriate plan of consolidation, which would primarily include savings on large categories of current public spending and to a lesser extent on increasing certain taxes, a significant decrease of the fiscal deficit could be achieved next year.

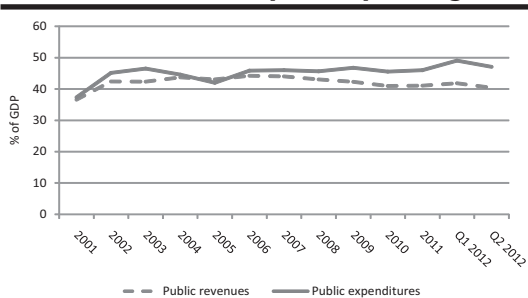
### General tendencies and macroeconomic implications

**Consolidated fiscal deficit in Q2 stood at 56.1 billion Dinars (about 6.7% of quarterly GDP)**

The consolidated fiscal deficit in Q2 2012 stood at 56.1 billion Dinars, or about 6.7% of the quarterly GDP, which is about 21 billion Dinars higher than the planned deficit (agreed with the IMF). The achieved compared to the planned fiscal deficit is to a great extent the consequence of the rise in public expenses above the planned and the fact that instead of a moderate growth of the GDP, 2012 will see a drop in economic activity by 1%, which has a negative effect on the public revenue. On the other hand, the negative effect of the slowing down of economic activity at the level of public revenue was partly compensated by the increase in the absorption gap (deviation of the real deficit of the current account balance of payments from the equilibrium level) which led to a growth of revenues from VAT and customs. However, the assessment is that the second half of the year will see a lowering of the absorption gap (due to the slowing down of imports and/or growth of exports) and these positive effects on the level of public revenue are expected to decrease so that the overall (negative) effect of the drop in economic activity on the level of public revenue will be greater.

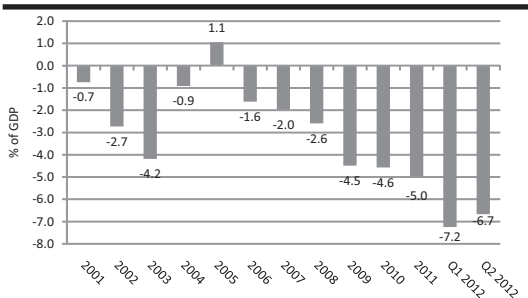
The overall fiscal deficit in the first half of 2012 stood at 110.3 billion Dinars or about 6.9% of the half year GDP. If the existing macroeconomic trends continue and without the implementa-

**Graph T6-1. Serbia: Consolidated public revenue and public spending**



Source: QM Calculation

**Graph T6-2. Serbia: Consolidated fiscal balance**



Source: QM Calculation

***Slight rise in public revenue is insufficient to compensate strong growth of public spending***

tion of measures for a strong fiscal consolidation we expect the consolidated fiscal deficit in 2012 to stand at about 210 billion Dinars (about 6.5% of the GDP) which is more than 2% of the GDP higher than planned.

The deviation of the fiscal deficit from the planned is the consequence of significantly faster rise in public spending compared to revenue growth.

The trend of a moderate real growth of public revenue continued in Q2 both compared to the previous quarter and compared to the same period of the previous year with the growth in Q2 somewhat slower than in the previous quarter. Because of significant oscillations in trends in public revenue and public spending in Q1 and Q2 caused by political and economic reasons, an evaluation of fiscal trends requires an observation of their movement at the level of the entire first half of 2012. We noticed that the real seasonally adjusted public revenue in the first half of 2012 rose slightly compared to the second half of 2011. The assessment is that the rise in revenues is the consequence of a growth of the physical level of imports and its real value which came about because of a strong depreciation of the Dinar from the start of the year, intensified state efforts to collect taxes and social contributions on employee salaries and the effects of once-off factors. Despite the moderate growth of real seasonally-adjusted public revenue, their amount continues to be lower than planned, primarily because of unrealistic assumptions about GDP trends and macroeconomic tax bases in 2012 which the budget for that year was based on and because of somewhat stronger recession tendencies in the global and domestic economies in the first half of 2012. As we said, the increase of the absorption gap partly eased the negative effects of the recession trends on public revenue, but that cannot be expected to happen in the coming period since the absorption gap is expected to decrease.

Following the strong growth recorded in Q1, the real seasonally-adjusted public expense dropped slightly in Q2 compared to the previous quarter. The described dynamics of public spending is the consequence of the election cycle, since all of Q1 was the pre-election period which saw a strong rise in current public spending, which made the basis for comparison in Q2 high and also in the second half of Q2, following the end of the elections, there was a slowing down in public spending trends. That trend in public spending in Q2 is the consequence of a moderate growth in expenses for employees, pensions, purchase of goods and services and other current expenses, a significant drop in capital expenses and expenses for subsidies and a moderate drop in all other categories of public spending. Viewed from the level of the first half of the year, the real seasonally-adjusted public expenses recorded a significant growth compared to the second half of the previous year. The rise in expenses for subsidies is the consequence of the political (election) cycle, which caused a speedier implementation of certain subsidy programs. The rise in expenses for goods and services and for employee salaries was considerably triggered by redistribution of revenues from wage tax in favor of local government, which allowed them a significant increase in allocations for those purposes, especially in the pre-election period. From the perspective of the annual fiscal deficit, the fact that the rise in expenses in the first half of the year (especially in Q1) is a once off thing and has no lasting character (for example early payments of subsidies) is assessed as favorable and we can expect them to slow down in the rest of the year. On the other hand, there is a risk of the introduction of new subsidies (because of the drought, for liquidity loans for the economy and similar) which would, without the implementation of compensating measures in the form of reducing other subsidy programs, which were not announced, lead to the overall expenses for subsidies being higher than planned in 2012.

**Table T6-3. Serbia: Consolidated General Government Fiscal Operations<sup>1)</sup>, 2008-2012**

	2008	2009	2010	2011	2012		
					Q1	Q2	Q1-Q2
I TOTAL REVENUE	1145.9	1,147	1,223.4	1302.5	312.6	339.8	652.4
II TOTAL EXPENDITURE	-1195.7	-1247.9	-1,329.9	-1435.9	-362.1	-390.3	-752.4
III "OLD" DEBT REPAYMENT, NET LENDING AND RECAPITALIZATIONS	-19.1	-20.4	-29.9	-24.9	-4.7	-5.6	-10.3
IV TOTAL EXPENDITURE, GFS (II+III)	-1214.8	-1268.3	-1,359.8	-1460.8	-366.8	-395.9	-762.7
V CONSOLIDATED BALANCE (I+IV), GFS definition <sup>3)</sup>	-68.9	-121.8	-136.4	-158.2	-54.2	-56.1	-110.3
VI ACCOUNT BALANCE CHANGE	-55.4	45.4	-19.2	187.7	-19.9	-22.4	-42.3
VII PRIMARY BALANCE	-46.5	65.6	-102.2	-113.4	-38.8	-42.7	-81.5

Source: Table P-10 in Analytical Appendix

1) Includes all levels of government (central, provincial and municipal) and their budget beneficiaries and social security organizations (Serbian Pension and Disability Insurance Funds, Health Insurance Funds, National Employment Service, but not public enterprises and the NBS).

2) The item corresponds to the item "Net acquisition of financial assets for policy purposes" in the PFB (in accordance to GFS 2001), i.e. to the item "net lending" or "lending minus repayment" in the IMF presentation (i.e. GFS 1986). It comprises loans to students, financing of the National Corporation for Housing Loan Insurance and the like.

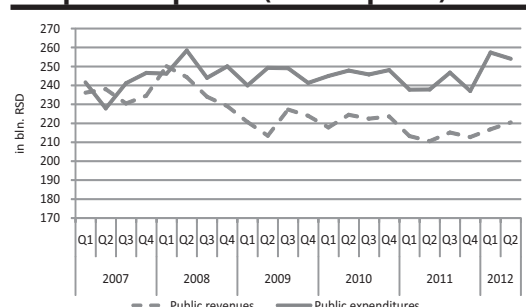
3) See Table P-10 in Analytical appendix and/or Box 2.

## Analysis of dynamics and structure of public revenues and public expenses

*Consolidated public revenues continue slight rise in Q2*

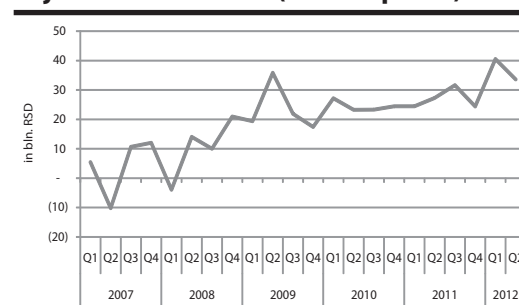
The consolidated seasonally-adjusted real public revenue in Q2 2012 were 1.7% higher compared to the previous quarter and the real rise in public revenue (of 3.3%) was registered in comparison with the same period of the previous year.<sup>1</sup> The rise in consolidated public revenues in Q2 was recorded in almost all basic types of public revenues. Viewed from the level of the first half of 2012, the real seasonally-adjusted public revenues grew by 2.2% compared to the second half of the previous year, primarily because of the significant growth of revenues from VAT on imports, corporate income tax and a moderate rise in income from labor taxes.

**Graph T 6-4. Serbia: Consolidated seasonally-adjusted real public revenues and public expenses (in 2006 prices)**



Source: QM Calculations

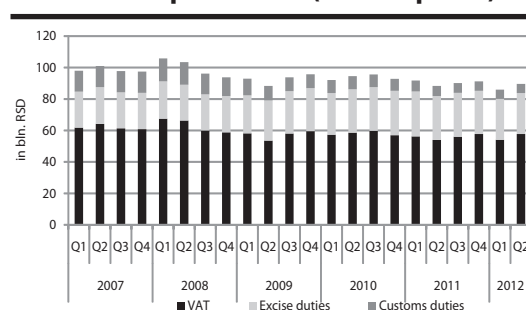
**Graph T 6-5. Serbia: Real seasonally-adjusted fiscal deficit (in 2006 prices)**



Source: QM Calculations

*Revenues from consumption taxes are rising*

**Graph T 6-6. Serbia: Trends in real consolidated seasonally-adjusted revenues from consumption taxes (in 2006 prices)**



Source: QM Calculations

The overall real seasonally-adjusted revenues from consumption taxes (VAT, excise duties and customs duties) in Q2 2012 rose compared to the previous quarter, with the revenues from VAT showing a significant growth while the real seasonally-adjusted revenues from excise duties stagnated (compared to Q1). Viewed at the level of the entire half of the year, the real seasonally-adjusted revenues from VAT recorded a slight growth (primarily VAT on imports), while the income from both excise duties and customs duties saw a moderate drop compared to the second half of the previous year.

1 Data in y-o-y real growth of consolidated public revenues, consolidated public expenses, according to economic classification, are given in Annex 1, while the data in the absolute amount of nominal public revenues and public spending is given in Annex 2.

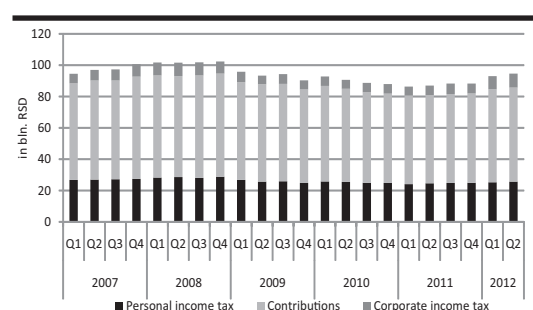
The rise in revenues from VAT is the consequence of an increase in the absorption gap, since imports are VAT taxable, while exports are VAT exempted. However, since the coming period is expected to see a lowering of the current account deficit in the balance of payments, and consequently a drop in the absorption gap, the assessment is that the rise in revenues from consumption taxes, paid on imports is temporary and will decrease with time.

Q2 saw a speedier growth of the real seasonally-adjusted revenues from VAT, which were 2.8% higher than in Q1, while the real revenues from VAT compared to the same period of the previous year were 1.5% higher and similar trends continued in July.<sup>2</sup> Namely, although Q2 saw negative trends continue in economic activity, there was also a change of structure of the GDP, in favor of increased imports and lower exports, which had a positive effect on VAT revenues. The re-balancing of the economy, contrary to the processes in 2009 and 2010, following the first wave of the crisis, is the consequence of the growth of the physical level of imports, and especially its Dinar value caused by a strong depreciation of the Dinar. The conclusion that the rise in VAT revenues in Q1, and especially in Q2, is the consequence primarily of growth of imports, is confirmed by the data on trends in VAT revenues on domestic consumption and imports. The real seasonally-adjusted VAT revenues paid on imports in the first half of 2012 is 7.1% higher compared to the previous six month period while the real seasonally-adjusted revenue from domestic VAT (paid on supply of domestic goods and services) is lower by 13.1%, compared to the second half of the previous year. Although that change in the foreign exchange is favorable from the point of view of public revenue, it is assessed to be extremely unfavorable from the point of view of long-term economic growth and the balance of payments equilibrium of the country and as such is not sustainable in the long term.

The real seasonally-adjusted revenues from excise duties in Q2 almost stagnated compared to the previous quarter. It is assessed that the stagnation of revenue from excise duties in Q2 is the result of lower consumption of products subject to excise duties, a lowering of duties on oil products early in May 2012 and the fact that the deadline to pay duties for the second half of June fell over a weekend, which meant that some of those dues were paid early in July, and a reduction of maneuvering space for tax evasion through the introduction of duties on heating oil.

For the first time after two years, the real seasonally-adjusted revenue from customs duties did not record any significant drop compared to the previous quarter, but was at almost the same level in Q2 as in Q1, which is the consequence of a growth of imports and the depreciation of the Dinar against the Euro.

**Graph T 6-7. Serbia: Trends in real consolidated seasonally-adjusted revenues from taxes on production factors (in 2006 prices)**



Source: QM Calculation

In that context, starting from July 1, 2012 an obligation was imposed on banks to report to the Tax Administration on salaries paid at a daily level, which allowed for more efficient control by the

The real seasonally-adjusted revenues from taxes on personal income and social security contributions in Q2 rose moderately compared to Q1 (by 1.8% and 1% respectively), and a moderate growth was recorded in the entire first half of 2012 compared to the previous six month period. The growth of revenues from taxes on production factors is the consequence of a growth of wage bill, which came about because of a regular indexation of salaries in the public sector in April and because of an extraordinary increase in salary payments for employees especially at local level. Besides that, from the start of 2012 the government stepped up its efforts to collect social security contributions. In that

<sup>2</sup> The assessment of the growth rate for real seasonally-adjusted revenue from VAT in Q2 compared to Q1 2012 was completed following the transfer of 4 billion Dinars from January 2012 to December 2011, because of a technical delay in refund of VAT in December 2011, which QM 28 wrote about.



## 6. Fiscal Flows and Policy

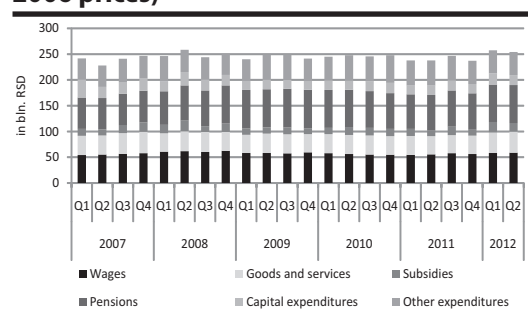
government. At the same time, there were statements that in that context further reforms of the system of collecting personal income tax and social contributions would be introduced along with the stipulation preventing banks from paying salaries without orders to pay the accompanying public revenues. The preliminary assessments on revenues from social contributions in July 2012 showed that the new measures did not lead to a significant increase in collecting them (the real seasonally-adjusted revenues from social contributions rose in July by 1% compared to June) and that a wider range of measures should be drawn up and implemented to raise the level of collection of social contributions (increasing the frequency of controls by the Tax Administration, raising fines, simplifying the system of paying contributions, etc). Also, the assessment is that the failure to collect taxes and contributions is to a great extent the consequence of insolvency of companies and entrepreneurs which cannot operate at a profitable level if they paid those charges in full in the given conditions. That is why the improvement of competition and productivity of the economy is also a vital condition to lower the rate of labor taxes evasion.

In Q2, the trend of a strong growth of real seasonally-adjusted revenues from corporate income tax continued, since they were 7.4% higher than in the previous quarter. The growth of income from corporate income tax is explained among other things with the fact that some of biggest public companies and companies in which the state is co-owner (such as the EPS and NIS) had relatively high profits in 2011 and their advance payments of corporate income tax in 2012 were

also increased. The estimate is that the rise in profits in 2011 and the subsequent rise in income from corporate income tax in 2012 is temporary because it was caused by an appreciation of the Dinar in 2011 (that is positive exchange rate differences on that basis). The assessment is that if the current macroeconomic trends continue without changes in the parameters of those taxes, 2012 and the next year will see a drop in income from corporate income tax.

Following a slight rise in Q1, the real seasonally-adjusted other tax and non-tax revenues saw a higher growth in Q2 compared to the previous quarter.

**Graph T 6-8. Serbia: Trends in consolidated seasonally-adjusted public expenses (in 2006 prices)**



Source : QM calculation

**Public spending slows in Q2**

The real seasonally-adjusted expenses of the consolidated government sector in Q2 2012 dropped by 1.3% compared to the previous quarter with the drop being most pronounced in expenses for subsidies and capital expenses. The drop in expenses in Q2 compared to Q1 is the consequence of the fact that they grew strongly in Q1, which raised the basis for comparison. Compared to the same period of the previous year, the consolidated public expenses in Q2 2012 rose in real terms by 9.5%.

At the level of the first half of 2012 the real seasonally-adjusted public spendings rose by 5.7% compared to the second half of 2011 primarily because of the rise in expenses for subsidies, goods and services and employee salaries.

**Expenses for goods and services, for employees, for pensions and other current expenses are rising**

Expenses for the purchase of goods and services (real, seasonally-adjusted) in Q2 were 1.9% higher compared to Q1, which is especially significant bearing in mind the fact that this category of expense saw a strong growth (of almost 12%) in the previous quarter. The estimate is that the rise in expenses for goods and services is to a great extent the consequence of the redistribution of revenues from wage tax in favor of local government, which allowed them to raise the spending for those purposes indicating an increase of the non-productive spending of public revenues.

Expenses for employees and for pensions (real, seasonally-adjusted) rose slightly in Q2 by 1.4% and 1.2% respectively compared to the previous quarter, primarily because of a regular indexation of those expenses in April by 3.5%, but also due to a special increase in expenses for salaries at the local level. Also, the real growth of expenses for employees (by 6.4%) was recorded in Q2

compared to the same period of the previous year, which is the consequence of a regular indexation of salaries, the introduction of a regular monthly payment of pay supplement of 10,000 Dinars a month for all employees in the police starting from the second half of the previous year, and a special and uncontrolled increase in salaries at the local level.

The most pronounced growth in Q2 was recorded with other current expenses which grew by 10.2% compared to Q1 (real, seasonally-adjusted).

***Subsidies and capital expenses drop strongly***

Following the strong growth in Q1, the real seasonally-adjusted expenses for subsidies recorded a strong decline of 17.2% in Q2 compared to Q1. That drop is the consequence of the fact that in Q1, because of the election cycle, certain subsidy programs were implemented early and speedily (for example for agriculture) in amounts planned for the whole year. Since new subsidy programs were introduced in the meantime (to deal with the consequences of the drought, for liquidity, etc.) without reducing the existing programs, the assessment is that there is a significant risk of the overall expenses for subsidies in 2012 exceed the planned amount. Since the new subsidy programs were socially and economically justified to a great extent, with the overall amount of expenses for subsidies in Serbia standing very high (compared to the countries of the region and EU member states), the estimate is that the introduction of these subsidy programs should be accompanied with a reduction of other existing subsidy programs (for example for investments and employment, etc).

Following the rise in Q1, the real seasonally-adjusted capital expenses drop significantly in Q2 (by 11.9% compared to the previous quarter). The reduction of the capital expenses in Q2, which is assessed as very unfavorable, is the consequence of the fact that in Q1 a part of the arrears brought forward, from previous quarters were settled, which makes the basis for comparison in Q2 higher and the fact that because of the big fiscal deficit and possible liquidity crisis, the priority in realization was given to current expenses (for salaries, pensions, goods and services), which led to a postponing of realization and payments for the purchase of capital goods.

***...while expenses for interest payments drop slightly***

The seasonally-adjusted expenses for interest payments in Q2 dropped in real terms by 1.3% compared to Q1. The slight drop in expenses for interest payments could be the consequence of the dynamics of debts maturity. Since the level of public debt in Serbia is growing in continuity and greatly and new loans are taken out at higher interest rates than the average interest rate on the existing government debt (due to the growing debt of the government, the lack of a credible plan for strong fiscal consolidation) with a depreciation of the Dinar against other foreign currency, the assessment is that a rise in expenses for interest payments can be expected in the coming period.

## **Analysis of fiscal trends at different levels of the government**

***Revenues at local level rising much faster than at other levels of government***

The disaggregated fiscal data by level of the government show divergent trends in public revenue and public expenses at different government levels. Of all three relevant levels, only revenues at local level recorded a strong growth in real terms in Q2 compared to the same period of the previous year (by 31.4%), while revenues of the Republic budget dropped gradually (-0.2%). At the same time revenues of the Republic Health Care Fund (RFZO) rose moderately (3.7%) compared to Q2 2011. The growth of revenue at the local level, much more quickly than the rise in expenses from the consolidated budget, was achieved primarily on the basis of redistribution of revenues from wage tax, from the Republic budget to local government budgets. Also, there is a moderate growth in real terms of the local authorities revenues from property taxes, which could indicate greater efforts by local public revenue offices on a more realistic assessment of the basis for the calculating of those taxes.

***...which leads to a strong growth in current public spending at local level***

On the other hand, public expenses at local level in Q2 rose significantly faster than expenses at other levels of the government and compared to the overall consolidated public expenses. The rise in expenses at local level covers mainly the increase in salaries, growth of expenses for the purchase of goods and services, subsidies and social security. Unlike previous quarters, Q2 recorded a rise of capital expenses.

## 6. Fiscal Flows and Policy

**Fiscal decentralization led to rise of consolidated fiscal deficit in Q1 and Q2 2012 by about 15 billion Dinars.**

The rise in expenses to purchase goods and service could be the consequence of settlement of arrears, created by the local governments in previous periods, which is seen as desirable. However, since those expenses have shown strong growth for the third quarter in a row, this could possibly be a lasting increase in the spending of funds for goods and services. Besides that, a significant rise in expenses on employees and subsidies for the third quarter in a row indicated that there is a risk for additional funds from wage tax being used for a permanent increase in public spending. In that case, the consolidated fiscal deficit would increase by the entire sum of the redistributed revenues from wage tax, which at the level of the first half of the year 2012 stands at about 15 billion Dinars. To reduce the negative effect of fiscal decentralization on the revenue side, at the level of the consolidated fiscal deficit, the recommendation is to return at least a part of the revenues from wage tax to the central level or to transfer part of the functions from Republic to local level.

**Table T6-9. Serbia: Rate of real y-o-y growth of public revenue and expenses at all level of power**

	Q2 2012/Q2 2011			
	Consolidated budget	Budget of the Republic	Health insurance fund	Local self-governments
A Total public revenues (I)+(II)	4.8	-0.2	3.7	31.4
I Current revenues (1)+(2)	4.5	-0.7	5.4	39.1
1. Tax revenues	5.3	0.3	5.7	52.4
1.1. Customs	-8.6	-8.6	-	-
1.2. Personal income tax	4.6	-48.3	-	74.6
1.3. Corporate income tax	39.9	34.0	-	-
1.4. VAT	6.9	6.9	-	-
1.5. Excise duties	-3.0	10.0	-	-
1.6. Property taxes	12.7	-	-	12.7
1.9. Other taxes	7.6	-5.7	-	7.9
1.10. Social security contributions	6.1	-	5.7	-
2. Non-tax revenues	-1.1	-7.8	-21.6	8.3
II Capital revenues	270.4	208.0	96.4	2,356.3
III Transfers from the other levels of government	0.0	-	-0.5	1.4
B Total public expenditures (I)+(II)+(III)	9.0	6.1	0.7	23.5
I Current expenditures	9.0	9.8	0.7	20.6
1.1 Wages	6.3	7.7	2.1	12.8
1.2 Social contributions on behalf of employer	15.1	27.2	-2.2	31.2
1.3. Goods and services	6.6	6.1	-352.1	57.9
1.4 Interest payments	56.4	65.9	-	29.8
1.5 Subsidies	2.2	-21.4	-8.5	13.6
1.6 Social insurance and social assistance	0.0	9.4	-	-
1.7 Transfers to the other levels of government	37.1	53.3	-	2.3
1.8 Other current expenditures	9.4	-14.8	-	35.4
II Capital expenditures	0.0	-27.7	-	57.4
IV Net lending	-45.7	-54.2	-	-41.0

Source: QM Calculation

## Analysis of public debt trends

**Serbia's public debt at the end of Q2 stood at 15.3 billion Euro (54.9% GDP)**

According to official data from the Finance Ministry, Serbia's total foreign debt stood at 15.3 billion Euro which is about 660 million Euro more than at the end of Q1. The estimate is that the public debt at the end of Q2 stood at about 54.9% GDP.<sup>3</sup> Figures for July show that at the end of that month the public debt was higher by 190 million Euro, amounting to 56.3% of GDP. The rise in public debt in Q2 is, to a great extent (about 490 million Euro) the consequence of the rise of public debt by 190 million Euro so that it stood at 56.3% of the GDP. The growth of public

<sup>3</sup> Calculated against the sum of the GDP in Q2 and the previous three quarters.

debt in Q2 is mainly (along with 490 million Euro) is the consequence of a fiscal deficit in Q2, depreciation of the Dinar and the drop in the real GDP.

Also, the growth of the public debt in Q2, besides the fiscal deficit, was caused by the government intervention to stabilize the banking sector (forming of New Agrobanka, help to the Vojvodina development bank and similar) to the extent of some 150 million Euro. The funds for those purposes can be recorded as expenses that is part of the fiscal deficit at the time those funds are paid (e.g. when the government issued bonds and paid the funds into the New Agrobanka capital) or at a moment when liabilities on the basis of issued bonds are paid. Whichever of those two approaches are used, they will lead to a growth in the public debt at the moment of borrowing. Regardless of the accounting treatment of those transactions, these are one-off expenses, which do not lead to a permanent increase in public spending and fiscal deficit, which is why those expenses should not be taken into consideration when assessing the scale and effects of the fiscal consolidation measures.

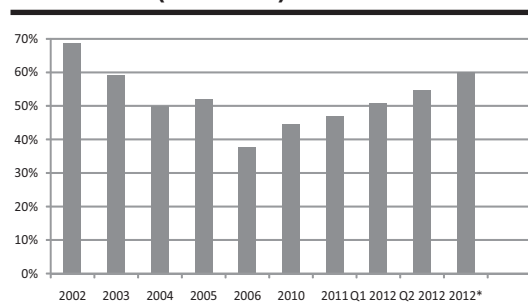
**Table T6-10. Serbia: Public debt 2000-2012**

	Amount at the end of period, in billions EUR										
	2000	2005	2006	2007	2008	2009	2010	2011	Q1 2012	Q2 2012	31.07.2012
I. Total direct debt	14.17	9.62	8.58	8.03	7.85	8.46	10.46	12.36	12.46	12.94	13,070.00
Domestic debt	4.11	4.26	3.84	3.41	3.16	4.05	4.57	5.12	5.33	5.55	5,592.30
Foreign debt	10.06	5.36	4.75	4.62	4.69	4.41	5.89	7.24	7.14	7.39	7,477.70
II. Indirect debt	-	0.66	0.80	0.85	0.93	1.39	1.71	2.11	2.15	2.34	2,399.70
III. Total debt (I+II)	14.17	10.28	9.38	8.88	8.78	9.85	12.17	14.47	14.62	15.28	15,469.70
Public debt / GDP	169.3%	50.2%	36.2%	29.4%	25.6%	31.3%	41.5%	45.07%			
Public debt / GDP (QM)	169.3%	52.1%	37.8%	30.9%	29.2%	34.8%	44.6%	46.9%	50.9%	54.9%	56.3%

*Liabilities related to guarantees are rising*

The new government debt in Q2 was almost equally distributed to domestic and foreign sources. Also, following the slowing down in Q1, there was a strong growth of guaranteed debt (increase by 190 million Euro in Q2). Since the estimate is that the annual increase in debt related to issued guarantees should not exceed 0.6% of the GDP, a strong growth in guarantees for the first half of the year (about 230 million Euro) is viewed as unfavorable, especially in the context of the fact that transparency and control of use of these funds by the parliament and the public is smaller. Therefore, we recommend a stricter approach to issuing guarantees by the government in the next period, both in terms of amount and in her choice of priorities which will have the greatest effect on economic growth and social development.

**Graph T 6-11. Serbia: Trends in Serbian Public Debt (% of GDP)**



Source: QM (\* for 2012 – QM taking medical tests)

period could also lead to added, extraordinary lending by the government. The estimate is that by the end of 2012 the country's public debt will reach 60% of the GDP which is equal to the maximum permitted level of the public debt to EU member states, that is 15% of the GDP more compared to the limit set in fiscal rules in Serbia. Since, the developing countries saw the crisis in liquidity and solvency at a much lower level of debt (at average 43% of the GDP in average), the estimate is that this level of debt in Serbia significantly raises the risk of a public debt crisis, that is a crisis of liquidity/solvency of the state, especially in the context of high instability at world

In conditions of a lack of credible measures for a strong fiscal consolidation, we estimate that the fiscal deficit in 2012 will significantly exceed the planned amount and will probably stand at about 6.5% of the GDP and could reach 7% of the GDP if new program expenses are added (13<sup>th</sup> monthly pension for people with low incomes, securing money for the FIAT project and similar). Even in cases when some savings were made and certain taxes were raised in the last quarter, the expected effect on the overall fiscal deficit in 2012 will be limited. Also, the state intervention due to the possible realization of risks in the banking sector in the coming period



## 6. Fiscal Flows and Policy

capital market. In that respect implementation of fiscal consolidation measures, primarily by lowering current spending and to a lesser extent through the raising of certain taxes, is necessary.

### Box 1. Downgrade of Serbia's credit rating – causes and consequences

Credit rating agency Standard & Poor's downgraded Serbia's rating at the beginning of August to BB-, negative outlook, which has been officially explained by the following: a) lack of credible plan of fiscal consolidation in pre-election period, which would provide sustainability of public finances, b) adoption of measures which jeopardize independence of the National Bank of Serbia, leading possibly to changes in monetary policy (and particularly to foreign currency reserves policy) which could have negative impact on financial stability and balance of payment position of the country. With almost the same explanation, soon afterwards, the other credit rating agency – Fitch, lowered the outlook of Serbia's credit rating from BB- stable to BB- negative. Empirical studies show that lowering credit rating of the country is related to increase in borrowing costs – downgrading credit rating by one level leads to increase in EMBI by 1.7%, triggering increase in interest rates (Flores (2010)). At the beginning of September 2012, EMBI for Serbia amounted to 580 basic points, which is by approximately 110 basic points higher than at the beginning of the year. At the same time, EMBI for Serbia is considerably higher compared to almost all countries in the region (Croatia and Hungary – around 380, Lithuania – around 230, Turkey – around 220, Bulgaria – around 130 basic points).

Based on the aforesaid, it is estimated that the recent changes to the Law on NBS, negative trends in economic activity in 2012 and lack of credible measures of fiscal consolidation would lead to increase in the borrowing costs, which could happen at the following issuance of Eurobonds in September. In addition, downgrading of credit rating has negative impact on the terms of borrowing of Serbia's corporate sector abroad, which would have adverse impact on its future growth. Negative effects of lowering credit rating on availability of new loans and the increase in borrowing costs can be temporarily mitigated through borrowing from non-commercial creditors (e.g. with some countries). However, this is not sustainable in the long run, because the funds which can be raised in that manner are limited.

## Appendices

### Annex 1. Serbia: Consolidated General Government Fiscal Operations<sup>1)</sup>, 2008-2012 (real growth in %)

	2008	2009	2010	2011				2012			
				Q1	Q2	Q3	Q4	Q1 - Q4	Q1	Q2	Q2/Q1
<b>I PUBLIC REVENUES</b>	<b>3.3</b>	<b>-8.7</b>	<b>-1.5</b>	<b>-2.8</b>	<b>-6.6</b>	<b>-3.8</b>	<b>-4.7</b>	<b>-4.6</b>	<b>1.7</b>	<b>4.8</b>	<b>5.6</b>
1. Current revenues	3.5	-9.1	-1.5	-2.9	-6.7	-3.8	-3.7	-4.4	1.7	4.5	5.2
Tax revenue	3.7	-8.8	-2.5	-3.1	-6.5	-4.3	-2.3	-4.1	1.9	5.3	4.8
Personal income taxes	6.3	-10.8	-3.9	-7.2	-3.5	-1.1	0.1	-2.9	4.6	4.6	11.8
Corporate income taxes	18.5	-27.0	-3.6	9.2	1.5	4.8	-3.7	3.9	51.5	39.9	-53.8
VAT and retail sales tax	2.5	-10.2	-0.7	-2.7	-7.9	-6.5	1.3	-4.0	-4.0	6.9	9.9
Excises	0.7	11.6	4.2	13.7	0.7	-0.9	-4.9	0.6	-5.7	-3.0	13.8
Custom duties	1.8	-32.4	-14.9	-15.9	-24.4	-23.1	-21.6	-21.5	-18.6	-8.6	13.9
Social contributions	4.3	-7.0	-6.5	-7.8	-5.3	-2.2	-0.6	-3.9	4.8	6.1	6.9
Other taxes	-2.3	-4.9	14.5	-7.4	-22.1	-11.5	-17.9	-15.2	-9.7	7.6	17.8
Non-tax revenue	2.6	-11.3	5.8	-1.0	-8.1	-0.5	-11.2	-6.1	0.1	-1.1	8.6
2. Capital revenues	-76.8	-41.4	-66.8	3330.6	47.9	746.3	1236.4	468.2	124.1	270.4	101.3
<b>II TOTAL EXPENDITURE</b>	<b>4.5</b>	<b>-4.8</b>	<b>-1.7</b>	<b>3.0</b>	<b>4.9</b>	<b>1.1</b>	<b>5.4</b>	<b>3.3</b>	<b>10.0</b>	<b>9.0</b>	<b>4.7</b>
1. Current expenditures	6.9	-3.3	-2.2	3.5	5.2	0.0	3.4	3.1	7.9	9.0	6.0
Wages and salaries	10.9	-6.0	-5.9	6.9	1.4	5.5	1.0	0.4	6.6	6.3	7.2
Expenditure on goods and services		-5.7	-0.3	0.7	3.6	6.5	4.7	4.3	9.5	15.1	19.4
Interest payment	-2.8	-5.7	-0.3	9.9	27.4	22.8	10.5	17.4	48.1	6.5	15.5
Subsidies	-13.3	19.0	40.6	19.2	26.1	15.3	24.1	7.4	42.6	56.4	8.3
Social transfers	10.1	-26.0	13.9	8.2	8.2	4.2	2.8	5.8	3.3	2.2	0.8
o/w: pensions <sup>5)</sup>	9.5	2.2	-3.9	9.8	5.0	2.0	1.2	3.9	8.4	7.4	1.7
Other current expenditures	14.9	6.7	-6.1	106.6	21.5	2.8	2.8	23.9	17.1	37.1	44.2
2. Capital expenditures	-4.3	-6.7	-11.8	6.3	1.4	13.9	19.8	5.3	48.4	9.4	12.8
<b>III "OLD" DEBT REPAYMENT, GOVERNMENT NET LENDING AND RECAPITALIZATIONS</b>	<b>12.3</b>	<b>-2.4</b>	<b>35.2</b>	<b>6.3</b>	<b>35.7</b>	<b>-49.7</b>	<b>-58.4</b>	<b>-25.6</b>	<b>-45.7</b>	<b>-35.9</b>	<b>15.9</b>
<b>IV TOTAL EXPENDITURE, GFS (II+III)</b>	<b>4.6</b>	<b>-4.8</b>	<b>-1.1</b>	<b>-2.9</b>	<b>-4.1</b>	<b>-0.2</b>	<b>-6.8</b>	<b>-3.8</b>	<b>7.5</b>	<b>8.5</b>	<b>4.9</b>

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

### Annex 2. Serbia: Consolidated General Government Fiscal Operations<sup>1)</sup>, 2008-2012 (nominal amounts)

	2008	2009	2010	2011				2012			
				Q1	Q2	Q3	Q4	Q1-Q4	Q1	Q2	Q1-Q2
I PUBLIC REVENUES	1,145.9	1,146.5	1,223.4	293.6	311.3	331.3	366.3	1,302.5	312.6	339.8	652.4
1. Current revenues	1,143.1	1,139.2	1,215.7	292.9	310.5	330.7	363.8	1,297.9	311.7	337.7	649.4
Tax revenue	1,000.4	1,000.3	1,056.5	259.1	272.0	286.8	313.1	1,131.0	276.3	298.1	574.4
Personal income taxes	136.5	133.5	139.1	32.7	37.9	37.9	42.3	150.8	35.8	41.2	77.1
Corporate income taxes	39.0	31.2	32.6	14.4	7.5	7.6	8.3	37.8	22.9	10.9	33.7
VAT and retail sales tax	301.7	296.9	319.4	79.3	80.9	86.6	95.7	342.4	79.7	90.1	169.8
Excises	110.1	134.8	152.2	35.1	40.2	46.9	48.8	170.9	34.6	40.6	75.2
Custom duties	64.8	48.0	44.3	9.0	9.5	9.7	10.6	38.8	7.7	9.0	16.7
Social contributions	312.7	318.8	323.0	78.3	85.6	86.9	95.9	346.6	85.9	94.6	180.5
Other taxes	35.6	37.1	46.0	10.2	10.5	11.4	11.5	43.5	9.7	11.7	21.4
Non-tax revenue	142.7	138.8	159.2	33.8	38.5	43.9	50.7	166.9	35.4	39.6	75.0
2. Capital revenues	1.4	0.9	0.3	0.3	0.3	0.3	1.1	2.0	0.6	1.3	2.0
	0.0										
II TOTAL EXPENDITURE	-1,195.7	-1,248	-1,329.9	-314.4	-343.9	-371.0	-406.7	-1,435.9	-362.1	-390.3	-752.4
1. Current expenditures	-1,089.6	-1,155	-1,224.8	-298.1	-323.9	-338.4	-364.4	-1,324.8	-336.8	-367.6	-704.4
Wages and salaries	-293.2	-302.0	-308.1	-76.7	-85.3	-89.6	-91.0	-342.5	-85.5	-94.4	-179.9
Expenditure on goods and services	-181.2	-187.4	-202.5	-44.7	-52.6	-51.0	-68.1	-216.3	-51.2	-63.0	-114.2
Interest payment	-17.2	-187.4	-34.2	-9.9	-12.1	-11.1	-11.7	-44.8	-15.4	-13.4	-28.8
Subsidies	-77.8	-22.4	-77.9	-15.1	-15.4	-28.4	-21.5	-80.5	-22.6	-25.2	-47.7
Social transfers	-496.8	-63.1	-579.2	-142.6	-150.4	-151.7	-164.2	-609.0	-154.2	-160.0	-314.2
a/w: pensions <sup>(9)</sup>	-331.0	-556.4	-394.0	-99.2	-105.4	-107.0	-111.2	-422.8	-112.5	-117.8	-230.3
Other current expenditures	-23.5	-387.3	-22.9	-9.1	-8.2	-6.6	-7.8	-31.7	-7.9	-11.7	-19.6
2. Capital expenditures	-106.0	-24.0	-105.1	-16.3	-19.9	-32.6	-42.3	-111.1	-25.3	-22.7	-48.0
III "OLD" DEBT REPAYMENT, GOVERNMENT NET LENDING AND RECAPITALIZATIONS	-19.1	-20	-29.9	-5.5	-9.9	-4.8	-4.7	-24.9	-4.7	-5.6	-10.3
IV TOTAL EXPENDITURE, GFS (II+III)	-1,214.8	-1,268.3	-1,359.8	-319.9	-353.8	-375.7	-411.4	-1,460.8	-366.8	-395.9	-762.7

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