6. Fiscal Trends and Policy

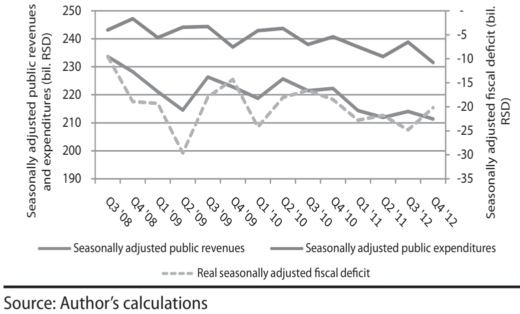
The fourth quarter of 2011 saw an additional dampening in real seasonally adjusted public revenues and public expenditures. The drop in revenues is mostly the consequence of a steep decline of other tax and non-tax revenues, while the drop of public expenditures was caused by the decrease of expenditures arising in connection with subsidies, employees and capital expenditures. The consolidated deficit registered in Q4 amounted to RSD 45.1 billion while the total consolidated fiscal deficit registered in 2011 totalled RSD 158.3 billion (4.7% of GDP), which is by about 0.2 percentage point to GDP more than planned. The deficit planned for the year 2012 amounts to 4.25% of GDP. The estimates are that the assumptions underlying the plan are relatively optimistic and there are significant risks that the fiscal deficit in 2012 could be quite above the planned figures, mainly since public revenues may be lower than planned. Thus, short-term fiscal consolidation measures must be applied to ensure that this year's deficit remains within the planned limits. In addition, it is necessary to prepare the fiscal consolidation plan which would ensure a decrease of the fiscal deficit by 2-3 percentage points of GDP in a relatively short term. Such plan would encompass the adoption of structural measures for the reduction of public spending and measures for the increase of public revenues, where the major part of the fiscal consolidation would be realized through the decrease of public expenditures, and its smaller part trough tax increase. Public debt at the end of 2011 amounted to EUR 14.5 billion (45.1% of GDP). Despite the fiscal deficit, Q4 registered a fall of public debt by about EUR 300 million, which may be attributed to the fact that the part of public debt due for payment in Q4 2011 was not financed by incurring additional debt, but from existing deposits.

General Trends and Macroeconomic Implications

Following the growth in Q3, public revenues mildly dropped again in Q4

Q4 suffered a mild drop in real seasonally adjusted public revenues of 1.2% compared to the previous quarter. The drop is mainly a consequence of a significant decline in other tax revenues, as well as non-tax revenues. Compared with the same period in 2010, total consolidated public revenues in Q4 2011 were lower in real terms by 4.7%. Even despite the slow-down in economic activity, real seasonally adjusted revenues from basic consumption taxes (VAT and excise duties) scored a mild growth in Q4 as compared to Q3, while revenues from personal personal income tax and social contributions hibernated and revenues from corporate personal income tax declined. Income from customs duties also continued to fall. Consolidated public revenues realized throughout 2011 were 4.6% lower in real terms than in 2010. The realization of public revenues that is below the amount planned in 2011 is a consequence of several factors: economic activity slump in the second half of the year, further liberalization of foreign trade, as well as the ambitious projections of public revenues and budget revisions.

Graph T6-1. Serbia: Seasonally Adjusted Real (Quarterly) Revenues and Expenditures in Public sector in Billions of RSD (2006=100)[1)]



Source: Author's calculations

1) Since SORS discontinued the publication of retail price indices conclusive with December 2010, from this issue of *QM-24* onwards, the recalculation of revenues and expenditures from nominal into real amounts to calculate the seasonally adjusted values will be made using the base consumer price index (2006=100).

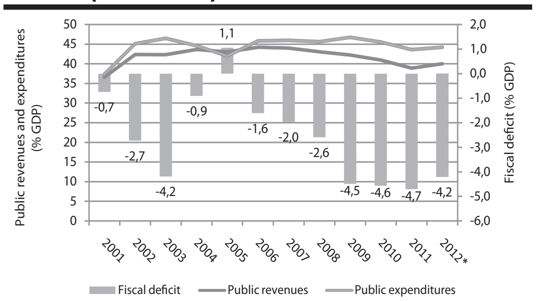
…while public expenditures in Q4 dropped again

Seasonally adjusted real public expenditures of a consolidated public sector marked a drop by 3.1% in Q4 compared to the previous quarter. A drop in public revenues registered in Q4 is a consequence of a slump in spending on employees and subsidies, as well as the reduction of capital spending. Consolidated expenditures of the public sector incurred in 2011 were lower in real terms by 3.3% compared to the figures in 2010. The greatest contribution to the decline in total public expenditures in 2011 was made by decreased spending on the purchase of goods and services and expenditures incurred in connection with subsidies and pensions.

The consolidated fiscal deficit in 2011 amounted to RSD 158.2 billion (4.7% of GDP)

As a result of these movements, the consolidated fiscal deficit realized in Q4 totalled RSD 45.1 billion, i.e. 5.2% of quarterly GDP. The consolidated fiscal deficit for the entire 2011 amounted to RSD 158.2bn (4.7% GDP), which is by 0.2 percentage point to GDP above the planned figure. Namely, according to the memorandum executed with the IMF in August 2011, the consolidated fiscal deficit for 2011 was planned in the amount of RSD 154.3bn, i.e. 4.5% of GDP. Given that the GDP growth rate in 2011 was 1.8%, the maximum fiscal deficit allowed by fiscal rules for the year amounted to 4.6% of GDP. It is estimated that a mild excess of fiscal deficit (by 0.1 percentage point to GDP) is a consequence of overstating certain categories of public revenues (excise duties in the first place) in the course of making these plans, as well as of the slowdown in economic activity towards the year-end, and the lack of adequate fiscal consolidation measures on the expenditure side. Also, it can be seen that towards the end of 2011 there was a slackening in VAT recovery, as well as in the realization of capital spending that increased revenues and decreased expenditures by the respective amounts. It is estimated that if there had been no slowdown in the VAT recovery rate and realization of capital expenditures, the 2011 fiscal deficit would have probably exceeded 5% of GDP.

Graph T6-2. Serbia: Consolidated Public Revenues, Public Expenditures and Fiscal Deficit (% of GDP)



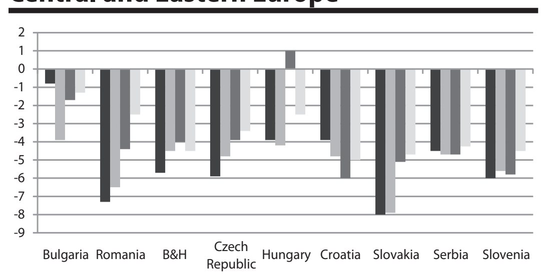
Source: *QM* calculation based on the data of the Ministry of Finance and Statistical Office

The high fiscal deficit in Serbia is structural in kind

At the onset of crisis in 2009, Serbia had a smaller fiscal deficit compared to the majority of other countries in the region and in Europe where this deficit generally exceeded 5% of GDP, among other reasons, because in other countries the decline in GDP figures in 2009 was higher than in Serbia. However, unlike other countries, most of which managed to reduce their fiscal deficit in the years that followed, Serbia's deficit remained at a relatively high level, between 4% and 5% of GDP in the following years (2010, 2011 and the same is planned for 2012). Although the decline in revenues caused by the slump of economic activity represents one of the factors that caused the relatively high fiscal deficit in Serbia, it is assessed that their influence is weaker than the influence of a structural imbalance in the Serbian public finances. Namely, the estimates show that even with the (natural) GDP growth rate of 4% annually, the fiscal deficit in Serbia would amount to 4% of GDP. This can be explained by the fact that the fiscal policy implemented in the years before the crisis was notably expansive, and entailed the adoption of tax cutting measures of a systematic character (e.g. 2007 wage tax) and measures for the increase of public spending (e.g. policy of regular and extraordinary indexation of wages in the public sector and pensions). Accordingly, Serbia entered the period of economic crisis with a relatively high structural fiscal deficit. To achieve a reduction of fiscal deficit within a relatively brief period from the present level of 4–5% GDP to the level of 2–3% of GDP, it will be necessary to implement fiscal consolidation structural measures. This could mainly be managed by cutting expenditures, but it would most probably also require a certain increase in taxes. Without applying these measures, even with a relatively speedy economic recovery, the fiscal deficit will be relatively high even in the ensuing years, threatening to increase public debt significantly above the allowed 45% of GDP.

In January, the Republic's budget revenues dropped and the deficit amounted to RSD 10.4 billion

Graph T6-3. Serbia: Consolidated Fiscal Deficit (% of GDP) in the Countries of Central and Eastern Europe



Source: UniCredit CEE Quarterly 1Q2012

The Republic's budget revenues in January 2012 were lower, in real terms, by 2.3% compared to the same month of the previous year. A notable fall in the Republic's budget revenues registered in January arose as a consequence of the redistribution of wage taxes in favour of local self-governments (starting from October 2011), decline in VAT revenues and significant decrease in other tax revenues, as well as customs duties. The decrease in VAT revenues was mainly caused by the slowdown in the VAT recovery rate towards the end of 2011, which was executed in January 2012. On the other side, revenues from excise duties registered a real growth of 32%, which is an outcome of the decision made by payers of excise duty on tobacco products to settle heir excise duties assessed upon determining the balance of inventories before the excise rate adjustment in January instead in December, as was the case in prior years. Apart from that, starting from January 2012, the Republic's share in the distribution of revenues from excises on oil derivatives increased from 80% to 100%, which resulted in higher inflows into the Republic's budget based on excises. It is estimated that the net effects of postponing VAT recovery until January, and lack of income from excises charged to inventories in December is almost matched, so the overall effect of these circumstances is neutral. On the other hand, total expenditures of the Republic budget incurred in January 2011 were about 11.9% higher than in the same month of the prior year, in the first place owing to (probably one-time) growth of expenditures arising from the purchase of goods and services, subsidies and capital spending. The growth of capital expenditures represents the consequence of postponing these payments in Q4, only to be made in January 2012. As a result of the movements described, the deficit in the Republic's budget in January 2012 was RSD 10.4 billion and, as such, it was somewhat lower than the average amount of monthly deficit in 2011, otherwise characteristic of January.

Table T6-4 Serbia: Consolidated Balance of the Public sector [1], 2008-2009-2010-2011

	2008	2009	2010	2011				
				Q1	Q2	Q3	Q4	Q1-Q4
I TOTAL REVENUE	1145.9	1,147	1,223.4	293.6	311.3	331.3	366.3	1302.5
II TOTAL EXPENDITURE	-1195.7	-1247.9	-1,329.9	-314.4	-343.9	-371.0	-406.7	-1435.9
III "OLD" DEBT REPAYMENT, NET LENDING AND RECAPITALIZATIONS	-19.1	-20.4	-29.9	-5.5	-9.9	-4.8	-4.7	-24.9
o/w Net lending [2]	-19.1	-20.4	-29.9	-5.5	-9.9	-4.8	-4.7	-24.9
IV TOTAL EXPENDITURE, GFS (II+III)	-1214.8	-1268.3	-1,359.8	-319.9	-353.8	-375.7	-411.4	-1460.8
V CONSOLIDATED BALANCE (I+IV), GFS definition [3]	-68.9	-121.8	-136.4	-26.3	-42.4	-44.4	-45.1	-158.2
VI ACCOUNT BALANCE CHANGE	-55.4	45.4	-19.2	59.4	51.9	96.3	-19.8	187.7
VIII TOTAL REVENUE/GDP (%)	43.1	42.3	41.8	38.2	36.3	38.6	42.4	38.9
IX TOTAL EXPENDITURE/GDP (%)	(45.6)	(46.7)	(46.5)	(41.6)	(41.3)	(43.7)	(47.6)	(43.6)
X CONSOLIDATED DEFICIT/GDP (%)	(2.5)	(4.5)	(4.7)	(3.4)	(5.0)	(5.2)	(5.2)	(4.7)

1) The General Government sector – all government levels (republic, province, municipalities) and their budget beneficiaries and mandatory social security organizations, (Pension and Disability Insurance Fund, Health Insurance Fund, National Employment Service), excluding public enterprises and the National Bank of Serbia (NBS).
2) The item corresponds to the item "Spending for the procurement of financial assets" in the PFB, i.e. to the item "net lending" in the IMF presentation. These are loans to students, farmers, loans granted through the Development Fund, repayment of debts to pensioners, and recapitalizations.
3) The consolidated balance (cash surplus/deficit according to GFC) is the difference between current revenues and proceeds from the sale of non-financial assets (i.e. capital revenues) and current spending and spending for the purchase of non-financial assets (i.e. capital spending). Beside those, spending also includes an item which encompasses the repayment of domestic debts – pensions, budgetary lending and recapitalization. The result defined in this manner, measures the liquidity impact of government transactions on the economy. See the methodology-related discussion in Box 1 in Quarterly Monitor No 3 for further details.

Box 1. Are Expectations of the Fiscal Framework for 2012 Reaslistic?

In December 2011, the Parliament of the Republic of Serbia passed the Law on Budget of the Republic of Serbia for the year 2012. According to this Law and the Report on the Fiscal Strategy for 2012 with projections for 2013 and 2014 – the plans for 2012 provide for the consolidated fiscal deficit of RSD 153 billion, i.e. 4.25% of GDP. The said fiscal deficit is within the limits defined by fiscal rules. However, it is estimated that the amount of planned public revenues for the year 2012 is considerably overstated for two reasons: i) a slower GDP growth then assumed at the moment of drafting the budget, ii) the overstatement of certain categories of public revenues in making these plans, compared to the movements of their macroeconomic bases. Given that the budget projections for 2012 rely on the assumption that the GDP growth rate will amount to 1.5%, the maximum budget deficit allowed would be 4.5% of GDP. But since the public debt at the end of 2011 exceeded the limit set at 45% of GDP – planning deficit in the amount below the maximum budget deficit allowed is a proper and justified step. On the other hand, the assumption of the GDP growth of 1.5% in 2012 is assessed as exceptionally optimistic. Based on the movements in the second half of 2011 and expected trends in the ensuing period – the scenario which entails a lower economic growth rate of 0.5% – or stagnation (see "Economic Activity"), is considered more realistic. Starting with higher estimated rates of economic growth – the amount of tax revenues is also overstated. Apart from that, it is estimated that individual projections of most significant items of public revenues are overstated even if assumed that GDP in 2012 will grow at the rate of 1.5%. And so the plan anticipates the growth of revenues from VAT and social contributions, although it is not reasonable to expect a significant real growth of personal consumption and income. Taking the aforesaid as a starting point, it is assessed that the total consolidated revenues for 2012 would be less than planned (by about 1% of GDP), that – without taking additional measures to save on the side of public expenditures and increase certain taxes – this would lead to a growth of fiscal deficit in 2012 significantly above the initially planned 4.25% of GDP. On a related matter, it is suggested that short-term measures of fiscal consolidation for 2012 should be analyzed and prepared to ensure the increase in public revenues and decrease in certain categories of public spending – and which could be put to work within a relatively short time period (if possible, already in mid 2012). Also, to secure long-term sustainability of the country's fiscal position – it is necessary that this year and the following one see the implementation of significant structural reforms which will achieve a decrease in fiscal deficit, in the first place by cutting public spending.

Analysis of Individual Forms of Tax and Individual Public Expenditures

Income from consumption taxes in Q4 registered a mild growth, while revenues from taxes on production factors stagnated, whereas other tax and non-tax revenues dramatically dropped.

VAT and Excise Duty Revenues Show a Mild Growth

Real seasonally adjusted revenues from VAT and from excise duties marked a rise in Q4 of 2.9% and 0.8%, respectively, compared to Q3 2011. Similar results are shown by the data relative to the year-over-year fluctuation in VAT revenues which, in Q4 for the first time after four quarters, scored a real growth (of 1.3%) compared to the same period of the previous year, while revenues from excise duties registered a decline (of 4.9%) compared to Q4 2010. The estimates are that the growth of VAT revenues is a consequence of a mild growth of personal consumption in Q3 and partially in Q4, as well as a slowdown in VAT recovery from the state at the year-end. In Q3 there was a real growth of wages bill for employees in the public sector, and both in Q3 and in Q4, a mild growth of real pensions bill was also registered, which could have spurred a moderate rise in personal consumption. This is also indicated by the movements in retail turnover, which registered a real decline in December as compared to the same month of the previous year – a lower than the average drop in retail turnover throughout 2011. The real growth of the wage bill in Q3 and pension bill in Q3 and Q4 is a consequence of regular indexations performed in May (to 5.5%) and October (to 1.5%), as well as low inflation in the second half of the year (November even recorded a deflation). In case the ensuing period sees the continuation of the price stabilization trend, the next regular indexation of salaries and pensions in the public sector will not bring any significant real growth of total revenues, so it cannot be expected that the trend of growth in domestic consumption and in revenues from taxes on consumption realized in this respect, continues. The year-over-year drop in revenues from excise duties registered in Q4 represents a consequence of the decision made by the manufacturers of tobacco products, to perform stock counting before the increase in excise duties – through indexation, and discharge their tax liabilities in January instead in December as was the practice in the previous years. Therefore, it is assessed that this is not a permanent drop of revenues earned on these basis, but a temporary oscillation. It is generally estimated that the movement of revenues earned from indirect taxation in the second half of the year was somewhat more favourable due to the effects of temporary factors, such as the increase in domestic demand due to the increase in wages and pensions and a faster growth of imports than exports – which is impossible to sustain – so the slackening in the movements of these tax revenues is to be anticipated.

Table T 6-5. Serbia: Seasonally Adjusted Quarterly Index of the Real Level of Public Revenue (Previous Quarter =100)

	Public revenues	Consumption taxes			Taxes on production factors			Other tax revenues	Non-tax revenues
		VAT	Excise duties	Customs duties	Personal income tax	Social contributions	Corporate income tax		
2009,Q1	96.9	98.6	105.9	93.8	93.5	95.7	87.9	92.9	93.6
2009,Q2	97.0	93.2	104.6	87.2	96.0	99.5	87.0	98.6	96.5
2009,Q3	105.5	107.8	110.4	93.2	100.6	99.8	104.9	121.6	118.1
2009,Q4	98.4	102.2	102.8	98.1	95.5	95.5	94.2	102.7	89.0
2010,Q1	98.2	95.9	89.4	97.7	104.5	103.0	104.6	101.0	101.5
2010,Q2	103.2	103.5	109.8	102.2	98.6	97.6	99.4	110.6	111.1
2010,Q3	98.1	101.3	102.0	93.9	97.9	96.7	97.7	92.0	94.4
2010,Q4	100.4	95.1	103.4	93.0	99.0	98.4	105.0	100.8	109.7
2011,Q1	96.4	98.5	99.4	94.9	97.7	99.9	100.6	91.5	87.4
2011,Q2	98.8	97.2	96.3	91.2	102.0	99.8	101.5	92.7	102.5
2011,Q3	101.0	102.9	101.0	95.4	100.9	100.3	101.2	103.7	101.3
2011,Q4	98.8	102.9	100.8	94.8	100.2	99.9	97.0	91.9	96.0
Index in Q4 2011 (Q1 2009=100)	92.6	98.2	127.0	51.1	86.7	86.6	80.8	95.9	96.5

Source: FREN calculation

...while revenues from personal income tax and social contributions stagnated

Revenues from personal income tax and social contributions were almost stagnant in Q4 compared to Q3. This is how the seasonally adjusted revenues from personal income tax in Q4 were 0.2% higher compared to Q3, while revenue from contributions for mandatory social insurance was 0.1% lower. Observed in comparison with the same period in 2010, revenues from personal income tax were higher in Q4 2011 in real terms by 0.1%, while revenues from contributions were lower in real terms by 0.6%. It is estimated that the stagnation of personal income tax and contributions in Q4 resulted in a mild rise in salaries in the public sector due to the regular indexation carried out in May and October, increase in minimal wages and further decrease of the real bill of legally paid salaries and other types of income in private sector, brought on by a decrease in formal employment (Labour Force Survey from November is indicative of a continued growth of unemployment – (see section 3 “Employment and Wages”)). As the movement in revenues from personal income tax and contributions (particularly in the second half of 2011) was under the effects of factors occurring on a one-time basis, their considerable growth cannot further be expected given that there is a slowdown in economic activities and increase in unemployment.

After the growth registered in the previous four quarters, real seasonally adjusted revenues from corporate income tax realized in Q4 dropped by 3% compared to the previous quarter. Observed in comparison with the same period in 2010, revenues from corporate income tax in Q4 2011 were lower in real terms by 3.7%. Corporate income tax is paid in advance based on the results realized in the previous year, which is used as an approximation of the business result expected in the current year. Hence, it is estimated that the decrease in revenues from this form of taxes may represent a consequence of deteriorating economic performances in the second half of 2011 based on which persons obligated to pay this tax are entitled to demand a decrease of corporate income tax paid in advance, as well as a consequence of further deterioration of liquidity in economy which could cause a reduction of the collection rate for this tax.

Q4 registered a sharp decline of other tax revenues, as well as of non-tax revenues. This is how real seasonally adjusted other tax revenues earned in Q4 were lower by 9.1% as compared to Q3, while non-tax revenues were 4% lower. Other tax and non-tax revenues earned in Q4 were lower in real terms by 17.9% and 11.2%, respectively, compared to the same period in 2010. A decline in other tax revenues is a consequence of a drop in revenues from local fees and charges. A strong real plummeting in these revenues may represent a consequence of the decrease in the number of transactions subject to these duties and/or decisions of certain local self-governments not to perform their indexation to the price growth rate in order to relieve the burden on economy. Except that, in Q3 a part of outstanding debt based on extra-profit tax was collected, which made the base used for the comparison in Q4 larger. On the other hand, a decline in non-tax revenues is a consequence of the fact that in 2011 dividend income was mostly collected in Q3 instead in Q4 as was the practice in the prior years.

Table T 6-6. Serbia: Seasonally Adjusted Quarterly Indices of the Real Level of Public Expenditures (Previous Quarter = 100)

	Public expenditures	Staff expenditures	Purchase of goods and services	Subsidies	Pensions	Capital expenditures
2009,Q1	97.3	95.9	99.2	79.1	103.3	81.2
2009,Q2	101.6	99.5	102.7	94.2	99.1	121.0
2009,Q3	100.1	99.0	97.5	106.1	100.8	84.7
2009,Q4	97.0	101.7	97.9	88.3	99.7	98.3
2010,Q1	102.5	98.7	105.5	115.2	98.6	114.4
2010,Q2	100.3	97.5	98.4	119.1	97.9	93.0
2010,Q3	97.7	97.8	100.1	89.9	98.7	102.9
2010,Q4	101.1	99.3	98.1	101.9	97.8	105.3
2011,Q1	98.5	99.8	101.1	101.3	96.1	100.1
2011,Q2	98.5	101.4	96.5	82.2	102.6	85.2
2011,Q3	102.2	103.3	98.1	128.8	102.2	115.9
2011,Q4	96.9	97.1	102.6	75.4	100.7	87.6
Index in Q4 2011 (Q1 2009=100)	93.7	91.1	97.2	71.0	97.3	81.8

Source: FREN calculation

In Q4, there was a mild change in the structure of public expenditures, due to a decline in expenditures arising in connection with employees, subsidies and capital expenditures and the growth of expenditures arising in connection with pensions and purchase of goods and services.

In Q4 public wages expenditures decreased while pension expenditures mildly grew

Real seasonally adjusted expenditures on wages in the public sector incurred in Q4 were lower in real terms by 2.9%, while expenditures arising in connection with pensions were 0.7% higher compared to Q3. Observed in comparison to Q4 2010, expenditures on wages paid in the public sector and pensions incurred in Q4 2011 were higher in real terms by 1% and 1.2%, respectively. In October 2011, in the regular process of indexation, wages in the public sector and pensions were indexed to 1.5%. The relatively modest nominal increase in wages and pensions in October is a consequence of a reduced inflation rate in the previous period. The real growth of expenditures arising from wages and pensions in 2011 is the outcome of the nominal increase by 5.5% in May after which there was a sudden plunge in inflation rate, and a mild nominal increase by 1.5% in October 2011. Also, the trend of decreases in inflation rates continued and so these nominal increases caused a real growth of expenditures arising in this respect.

Expenditures arising from subsidies experience a dramatic decline

Real seasonally adjusted expenditures arising from subsidies registered a decline in Q4 of even 24.6%, as compared to Q3, while expenditures incurred in this respect in Q4 2011 were lower in real terms by 24.1% compared to the same quarter in 2010. A strong decrease in expenditures on subsidies in Q4 represents the consequence of changes in budgetary policy envisaged by the revision of the Republic budget for 2011, setting out that a significant part of the fiscal consolidation on the side of expenditures is executed through the reduction of expenditures arising from subsidies. Total expenditures on subsidies in 2011 are lower in real terms by 7.4% compared to 2010, which represents a consequence of a decrease in fiscal stimuli at the beginning of 2011, given that the beginning of year saw a moderate recovery of economic activity, as well as a consequence of decreased subsidies in the second half of the year for fiscal consolidation purposes. As expenditures on subsidies in 2011 totalled almost 2.4% of GDP, which is significantly above the average amount of these expenditures in the member states of the EU, it is assessed that the cutdown of these expenditures, mostly discretionary in character, is justified and necessary. Besides, is it estimated that the ensuing period will also require a structural change of these expenditures, through the reduction of subsidies to public companies engaged in a commercial activity and operating with loss (Serbian Railways, Coal Mine Resavica), local public companies, social enterprises in restructuring, as well as incentives for investments and increase in subsidies to agriculture.

Expenditures arising from the purchase of goods and services experience growth

Real seasonally adjusted expenditures arising from the purchase of goods and services in Q4 increased by 2.6% compared to Q3, while these expenditures were 4.7% lower than in the same period in 2010. On the level of entire 2011, expenditures arising from the purchase of goods and services registered a real decline by 4.3% which is in accordance with the plan promoted by the revised budget of the Republic for the year 2011 that the decrease of public consumption is to a significant extent performed through this public expenditure category. The reduction of expenditures arising from the purchase of goods and services is rated as positive given that it refers to a decrease of the category of current expenditures, where the functioning of the public sector was not significantly impaired. However, it has come to attention that in certain public sector segments, such as the Republic Health Insurance Fund, significant defaults were created in the purchase of drugs and other consumables, which caused the reduction of expenditures incurred in connection with the purchase of goods and services, given that the budgetary accounting is conducted on cash receipt basis. Such practice is considered negative, given that it further aggravates the illiquidity of economy, while at the same time, data on the movement in public spending and actual amount of the country's public debt are obscured.

Table T6-7. Serbia: Consolidated Balance of the Public sector, 2008-2009-2010-2011

	2008	2009	2010					2011				
			Q1	Q2	Q3	Q4	Q1-Q4	Q1	Q2	Q3	Q4	Q1-Q4
I PUBLIC REVENUES	**1,145.9**	**1,146.5**	**266.6**	**292.9**	**309.5**	**354.4**	**1,223.4**	**293.6**	**311.3**	**331.3**	**366.3**	**1,302.5**
1. Current revenues	1,143.1	1,139.2	266.2	292.4	308.9	348.1	1,215.7	292.9	310.5	330.7	363.8	1,297.9
Tax revenue	1,000.4	1,000.3	236.1	255.6	269.3	295.5	1,056.5	259.1	272.0	286.8	313.1	1,131.0
Personal income taxes	136.5	133.5	31.1	34.5	34.4	39.0	139.1	32.7	37.9	37.9	42.3	150.8
Corporate income taxes	39.0	31.2	11.7	6.5	6.5	7.9	32.6	14.4	7.5	7.6	8.3	37.8
VAT and retail sales tax [1)]	301.7	296.9	71.9	77.3	83.2	87.0	319.4	79.3	80.9	86.6	95.7	342.4
Excises	110.1	134.8	27.2	35.1	42.5	47.4	152.2	35.1	40.2	46.9	48.8	170.9
Custom duties	64.8	48.0	9.5	11.0	11.3	12.5	44.3	9.0	9.5	9.7	10.6	38.8
Social contributions [2)]	312.7	318.8	74.9	79.4	79.8	88.9	323.0	78.3	85.6	86.9	95.9	346.6
Other taxes	35.6	37.1	9.8	11.8	11.5	12.9	46.0	10.2	10.5	11.4	11.5	43.5
Non-tax revenue	142.7	138.8	30.2	36.8	39.6	52.7	159.2	33.8	38.5	43.9	50.7	166.9
2. Capital revenues	1.4	0.9	0.0	0.2	0.0	0.1	0.3	0.3	0.3	0.3	1.1	2.0
II TOTAL EXPENDITURE	**-1,195.7**	**-1,248**	**-286.1**	**-317.8**	**-329.7**	**-396.3**	**-1,329.9**	**-314.4**	**-343.9**	**-371.0**	**-406.7**	**-1,435.9**
1. Current expenditures	-1,089.6	-1,155	-272.6	-300.5	-304.0	-347.7	-1,224.8	-298.1	-323.9	-338.4	-364.4	-1,324.8
Wages and salaries	-293.2	-302.0	-72.7	-76.0	-76.3	-83.1	-308.1	-76.7	-85.3	-89.6	-91.0	-342.5
Expenditure on goods and services	-139.9	-187.4	-39.7	-47.9	-49.0	-65.9	-202.5	-44.7	-52.6	-51.0	-68.1	-216.3
Interest payment	-181.2	-187.4	-8.0	-8.3	-8.2	-9.7	-34.2	-9.9	-12.1	-11.1	-11.7	-44.8
Subsidies	-17.2	-22.4	-11.2	-18.4	-22.1	-26.2	-77.9	-15.1	-15.4	-28.4	-21.5	-80.5
Social transfers	-77.8	-63.1	-137.1	-144.0	-142.3	-155.7	-579.2	-142.6	-150.4	-151.7	-164.2	-609.0
o/w: pensions [3)]	*-496.8*	-556.4	*-97.1*	*-97.5*	*-98.2*	*-101.3*	*-394.0*	*-99.2*	*-105.4*	*-107.0*	*-111.2*	*-422.8*
Other current expenditures	-331.0	-387.3	-3.9	-5.9	-6.1	-7.0	-22.9	-9.1	-8.2	-6.6	-7.8	-31.7
2. Capital expenditures	-23.5	-24.0	-13.5	-17.3	-25.7	-48.6	-105.1	-16.3	-19.9	-32.6	-42.3	-111.1
III "OLD" DEBT REPAYMENT, GOVERNMENT NET LENDING AND RECAPITALIZATIONS	**-19.1**	**-20**	**-4.6**	**-6.4**	**-8.5**	**-10.4**	**-29.9**	**-5.5**	**-9.9**	**-4.8**	**-4.7**	**-24.9**
IV TOTAL EXPENDITURE, GFS (II+III)	**-1,214.8**	**-1,268.3**	**-290.7**	**-324.2**	**-338.2**	**-406.7**	**-1,359.8**	**-319.9**	**-353.8**	**-375.7**	**-411.4**	**-1,460.8**

1) Turnover tax/VAT decreased by new tax credits approved to corporate entities.
2) Contributions decreased by set-offs between the Pension and Disability Insurance Fund ("PIO"), Development Fund and companies owing to the PIO Fund.
3) Covers only expenditures of current pensions.
Note:
The real growth is achieved by applying the average base retail price index (base December 2003) to quarterly data.

Capital expenditures drastically drop

Following the spike in the growth registered in Q3, real seasonally adjusted capital expenditures in Q4 dropped by 12.4% compared to Q3. Significant oscillations are noted in the fluctuation of capital expenditures, which may represent the consequence of postponing the realization and financing of certain capital expenditures in Q4, so the fiscal deficit would be kept within the planned limits. Although capital expenditures registered a real y-o-y growth in the first three quarters, due to a strong drop in Q4. Total capital expenditures incurred in 2011 were lower in real terms by 5.3% compared to the 2010 figures. A larger decline of capital expenditures compared to current ones in 2011 is assessed as unfavourable. Total capital expenditures incurred in 2011 approximated 3.3% of GDP and were significantly lower (by about 1.4 percentage points of GDP) than the fiscal deficit in that year, which points to the conclusion that the debt incurred by the state in the amount approximating 1.4 percentage points of GDP related to the financing of current consumption, the burden of which is *de facto* passed on to future generations. Capital expenditures were below the amount of fiscal deficit and greater in number in the previous years, which causes the impairment of the country's net asset position, given that debt accumulation exceeds the increase in the value of the country's assets.

Table T6-8. Serbia: Y-o-y Real Trends of Consolidated Balance of Public sector[1)], 2007-2008-2009-2010-2011

	2008	2009	2010					2011					
	Q1-Q4	Q1 - Q4	Q1	Q2	Q3	Q4	Q1 - Q4	Q1	Q2	Q3	Q4	Q1 - Q4	Q4/Q3
I PUBLIC REVENUES	**3.3**	**-8.7**	**-4.0**	**2.5**	**-3.6**	**-1.3**	**-1.5**	**-2.8**	**-6.6**	**-3.8**	**-4.7**	**-4.6**	**9.6**
1. Current revenues	3.5	-9.1	-4.0	2.6	-3.5	-1.4	-1.5	-2.9	-6.7	-3.8	-3.7	-4.4	9.0
Tax revenue	3.7	-8.8	-4.3	0.7	-3.0	-3.7	-2.5	-3.1	-6.5	-4.3	-2.3	-4.1	8.2
Personal income taxes	6.3	-10.8	-6.0	-3.8	-5.1	-1.2	-3.9	-7.2	-3.5	-1.1	0.1	-2.9	10.7
Corporate income taxes	18.5	-27.0	-15.2	7.5	-0.1	6.2	-3.6	9.2	1.5	4.8	-3.7	3.9	7.8
VAT and retail sales tax [1)]	2.5	-10.2	-3.5	6.4	1.1	-6.1	-0.7	-2.7	-7.9	-6.5	1.3	-4.0	9.5
Excises	0.7	11.6	3.9	6.8	2.4	3.4	4.2	13.7	0.7	-0.9	-4.9	0.6	3.3
Custom duties	1.8	-32.4	-23.1	-11.9	-10.4	-14.8	-14.9	-15.9	-24.4	-23.1	-21.6	-21.5	8.9
Social contributions [2)]	4.3	-7.0	-4.9	-6.9	-8.8	-5.5	-6.5	-7.8	-5.3	-2.2	-0.6	-3.9	9.4
Other taxes	-2.3	-4.9	23.3	36.8	3.9	2.1	14.5	-7.4	-22.1	-11.5	-17.9	-15.2	0.0
Non-tax revenue	2.6	-11.3	-1.6	18.1	-6.7	13.4	5.8	-1.0	-8.1	-0.5	-11.2	-6.1	14.6
2. Capital revenues	-76.8	-41.4	-97.6	-64.3	-26.0	69.6	-66.8	3330.6	47.9	746.3	1236.4	468.2	330.4
II TOTAL EXPENDITURE	**4.5**	**-4.8**	**-1.4**	**-3.1**	**-3.2**	**0.3**	**-1.7**	**-3.0**	**-4.9**	**1.1**	**-5.4**	**-3.3**	**8.7**
1. Current expenditures	6.9	-3.3	-1.9	-2.0	-3.7	-1.4	-2.2	-3.5	-5.2	0.0	-3.4	-3.1	6.7
Wages and salaries	10.9	-6.0	-3.7	-6.1	-4.4	-8.9	-5.9	-6.9	-1.4	5.5	1.0	-0.4	0.7
Expenditure on goods and services		-5.7	3.1	-5.1		2.2	-0.3	-0.7	-3.6	-6.5	-4.7	-4.3	32.4
Interest payment	-2.8	-5.7	3.1	-5.1	-1.9	2.2	-0.3	9.9	27.4	22.8	10.5	17.4	3.9
Subsidies	-13.3	19.0	29.1	71.1	5.8	75.0	40.6	19.2	-26.1	15.3	-24.1	-7.4	-24.8
Social transfers	10.1	-26.0	-5.3	16.6	9.2	26.8	13.9	-8.2	-8.2	-4.2	-2.8	-5.8	7.3
o/w: pensions [3)]	*9.5*	2.2	-3.8	-3.3	-5.5	-3.3	-3.9	-9.8	-5.0	-2.0	1.2	-3.9	3.0
Other current expenditures	14.9	6.7	-4.3	-5.6	-6.4	-7.9	-6.1	106.6	21.5	-2.8	2.8	23.9	18.1
2. Capital expenditures	-4.3	-6.7	12.7	6.6	-18.1	-27.2	-11.8	6.3	1.4	13.9	-19.8	-5.3	28.8
III "OLD" DEBT REPAYMENT, GOVERNMENT NET LENDING AND RECAPITALIZATIONS	**12.3**	**-2.4**	**360.3**	**-4.9**	**34.9**	**27.7**	**35.2**	**6.3**	**35.7**	**-49.7**	**-58.4**	**-25.6**	**-2.1**
IV TOTAL EXPENDITURE, GFS (II+III)	**4.6**	**-4.8**	**-0.1**	**-3.1**	**-2.5**	**0.8**	**-1.1**	**-2.9**	**-4.1**	**-0.2**	**-6.8**	**-3.8**	**8.5**

1) Turnover tax/VAT decreased by new tax credits approved to corporate entities.
2) Contributions decreased by set-offs between the Pension and Disability Insurance Fund ("PIO"), Development Fund and companies owing to the PIO Fund
3) Covers only expenditures of current pensions.
Note:
The real growth achieved by applying the average base retail price index (base December 2003) to quarterly data.

Analysis of Public Debt Trends

Public debt of Serbia at the end of 2011 stood at €14.5bn (approx. 45.1% GDP)

At the end of 2011, the total public debt of Serbia amounted to EUR 14.5 billion (45.1% of GDP), which is round EUR 300 million less than at the end of Q3 2011. In the QM assessment, the public debt at the end of 2011 totalled 45.2% of GDP and the departure from the assessment made by the Ministry of Finance represents the consequence of the fact that the ministry's official assessment in its comparison uses GDP which assumes the GDP growth rate in 2011 of 2% (and not of 1.8% as estimated by SORS). Although the fiscal deficit reached the amount of EUR 400 million in Q4, in the same period there was a decrease of the nominal amount of public debt due to the fact that a part of liabilities related to public debt due for payment in Q4 2011, as well as the current fiscal deficit in Q4, were not financed from new borrowings, but from the existing state deposits. The Serbia's public debt increased in 2011 by EUR 2.3 billion compared to the respective balance at end of 2010, which is substantially higher than the consolidated fiscal deficit which in 2011 amounted to EUR 1.5 billion. The state's borrowing in the amount exceeding the amount necessary to finance the fiscal deficit in 2011 provided for the increase of the state's deposits, which amounted to EUR 960 million, securing in advance the funds necessary to finance fiscal deficit in the part of 2012. Given that towards the end of 2011 there was a general deterioration of conditions on the international financial market, caused by the crisis in the Eurozone, and that the first half of 2012 represents a pre-election period when the potential for the ratification of loan agreements is limited, obtaining funds to finance deficit in the part of 2012 in advance is believed to be justified.

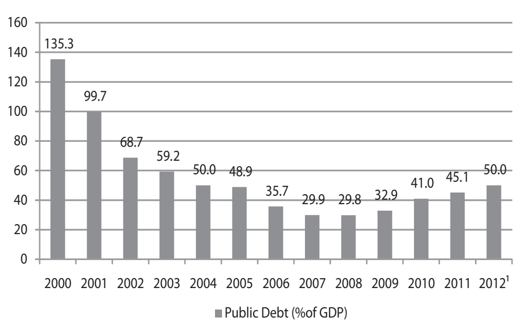
Table T6-9 Serbia: Public debt[1)] 2000-2011.

	Amount at the end of period, in billions EUR										
	2000	2005	2006	2007	2008	2009	2010	Q1 2011	Q2 2011	Q3 2011	Q4 2011
I. Total direct debt	14.17	9.62	8.58	8.03	7.85	8.46	10.46	11.01	11.58	12.62	12.36
Domestic debt	4.11	4.26	3.84	3.41	3.16	4.05	4.57	5.30	5.64	5.65	5.12
Foreign debt	10.06	5.36	4.75	4.62	4.69	4.41	5.89	5.72	5.94	6.98	7.24
II. Indirect debt	-	0.66	0.80	0.85	0.93	1.39	1.71	1.68	1.71	2.12	2.11
III. Total debt (I+II)	**14.17**	**10.28**	**9.38**	**8.88**	**8.78**	**9.85**	**12.17**	**12.70**	**13.29**	**14.74**	**14.47**
Public debt / GDP²	**169.3%**	**50.2%**	**36.2%**	**29.4%**	**25.6%**	**31.3%**	**41.5%**	**39.8%**	**40.6%**	**44.4%**	**45.07%**
Public debt / GDP (QM)³	**169.3%**	**52.1%**	**37.8%**	**30.9%**	**29.2%**	**34.8%**	**43.9%**	**43.2%**	**42.9%**	**45.6%**	**45.2%**

1) Under the Law on Public Debt, public debt includes the debt of the Republic under contract signed by the Republic, based on securities, contracts and agreements rescheduling the liabilities assumed by the Republic under earlier contracts, as well as securities issued under special laws, Republic's debt arising from guarantees issued or based on directly undertaken obligations in the capacity of a debtor for the debts secured by those guarantees, or counter-guarantees provided by the Republic, debt of local authorities on behalf of which the Republic provided the guarantee.
2) Estimate by the Serbian Ministry of Finance.
3) QM estimate (using as comparison basis the sum of nominal GDP in the current and previous three quarters.)
Source: Data provided by the Serbian Ministry of Finance and QM estimates

Out of EUR 14.5 billion of public debt – round EUR 12.4 billion relates to direct and EUR 2.1 billion relates to indirect liabilities of the government. By comparing data on the amount and structure of public debt, both at the end of Q3 and of Q4 2011, it may be inferred that in Q4 there was a net debt settlement of the government on domestic market, given that the internal direct debt dropped by about EUR 500 million compared to Q3, and there was a concurrent increase in the government's foreign liabilities (by about EUR 300 million). The change in the structure of public debt in Q4 is explained by the borrowing on the international financial market through the issue of Eurobonds, as well as a consequential reduction of borrowing on domestic market based on the issue of treasury bills. Although the decrease of debt on domestic market should have positive effects – given that it diminishes the government's crowding out private investments effect – the estimates are that such change in the source of financing carries certain risks. Namely, borrowing on the domestic market was mostly carried out in dinars, whereas borrowings on the international market were as a rule carried out in euros or dollars. Hence, the increased borrowings on international market in a foreign currency raises foreign exchange risk of sustainability of the Serbia' public debt, all the more as the share of debt denominated in foreign currencies is relatively high in Serbia (85.6%). The government's indirect liabilities at the end of Q4 were almost unchanged as compared to the balance at the end of the previous quarter. However, compared to the end of 2010, indirect liabilities grew by about EUR 400 million, which is a continuation of their trend of growth. Such movements in indirect liabilities are assessed as unfavourable as they point to the growing indebtedness of government in an indirect manner, through the issuance of guarantees, which increases the risks of failing to observe priorities in borrowings.

Graph T6-10: Serbia: Public Debt Trends Expressed as % of GDP (QM estimate)



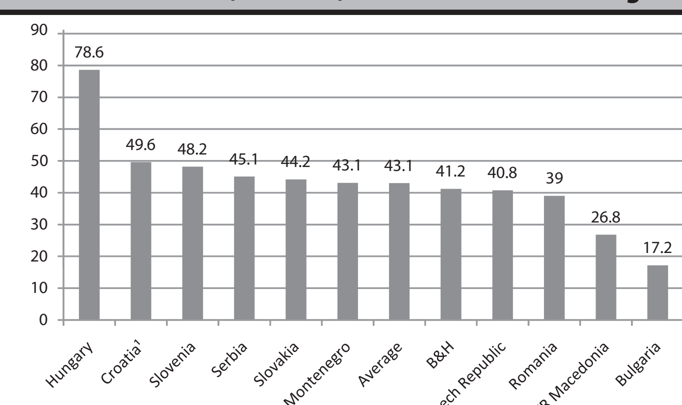
1) For 2012 - *QM* estimate

The public debt is a consequence of fiscal deficit in prior years. The relative amount of public debt (expressed as % of GDP) systematically depends on the movements in the primary fiscal balance, real interest rates, real exchange rate and GDP. So the growth of primary fiscal deficit and real interest rates, GDP decline and real Dinar depreciation have an adverse impact, while the GDP growth, Dinar appreciation and a decrease in interest rates positively influence the relative amount of public debt. Although the relative amount of public debt is an excellent indicator of the country's indebtedness level, there is no universal limit to the value of this indicator. Instead the limit of over-indebtedness differs from one country to another. This is how Argentina suffered bankruptcy at the end of the 20th Century at the level of public debt below 50% of GDP, while some other countries manage to keep top credit ratings even with several times higher indebtedness levels (e.g. Japan's public debt reaches 200% of GDP). The upper limit prescribed for the public debt of countries in the Eurozone amounts to 60% of GDP which usually misleads to the conclusion that the existing upper limit of the indebtedness level in Serbia of 45% of GDP is conservative, that there is room for its increase. The argument usually offered is the need to provide the impulse for economic growth by means of expansive fiscal policy primarily on the side of expenditures. The upper limit of public debt sustainability of a country depends on its basic macroeconomic performances and credibility it has with investors, which mostly reflects in the country's credit rating position. On the other hand, the efficacy of fiscal stimuli to enhance economic activity depends on the size of fiscal multipliers. Given that Serbia's credit rating is low, that costs of borrowings are consequently relatively high, it is assessed that the existing upper limit of debt of 45% of GDP represents a realistic limit corresponding to economic performances of Serbia. Upping this limit to 60% of GDP would considerably increase interest expenditures, as well as the probability of the country's sliding into a debt crisis. Aside from that, given that the amount of fiscal multipliers in Serbia is low, the efficacy of fiscal stimuli in enhancing the economic activity is limited, so the increase in these stimuli would raise public debt with very limited positive effects on economic activity. The conclusion that Serbia is nearing the upper limit of sustainable public debt is also compelled by the fact that in February there was a low level of realization in several auctions of treasury bills (denominated in euros and dinars). Additionally, bids for borrowings of Srbijagas also failed, as well as those for the allocation of agricultural loans. This testifies to the perception of increased risk for investors, given that the upper limit of prescribed level of borrowing is achieved, lack of measures which would decrease structural fiscal deficit and postponement of the revision of IMF arrangement. Should negative tendencies in respect of the degree of successful realization of treasury bills continue, short-term liquidity of the budget could be jeopardized, which would also have long-term negative consequences due to a psychological reaction.

Box 2. Level of public debt in the countries of the region

Due to a relatively high fiscal deficit in the period from 2009, the public debt of most countries in the region has increased considerably. The average amount of public debt incurred by the countries of the region at the end of 2011 totalled 43.1% of GDP. The level of debt was extremely high in Hungary and relatively high in Croatia, Slovenia and Serbia, whereas these figures for the FYR Macedonia and Bulgaria are the lowest. Among the countries of the region and according to the level of public debt, Serbia is one of the countries with largest debt (it is rated fourth out of 11 countries taken into consideration). It is considered particularly unfavourable that these countries with relatively high levels of indebtedness, are planning in 2012 a fiscal deficit between 4% and 5% of GDP.

Graph T6-11. Level of Public Debt (% of GDP) in the Countries of the Region at the End of 2011.



1) Public debt of Croatia, including liabilities of state-owned company Autoceste equals 59% of GDP

Although the level of public debt in the countries of the region is below the average of the member countries of the European Union, it is assessed that the risks of public debt sustainability of the countries of the region are more prominent – due to a lower credit rating and consequentially higher costs of borrowings, frequent oscillations in exchange rates of national currencies, lower level of development level, etc. – and for these reasons it is particularly important for these countries to implement the measures of fiscal consolidation, which would decrease their fiscal deficit and would gradually reduce their public debt.

Given that the public debt of Serbia towards the end of 2011 attained the level of 45% of GDP, it is certain that in 2012 it will exceed that limit even if the planned GDP growth rate of 1.5% is achieved, and fiscal deficit is not larger than the planned 4.25% of GDP. Short-term and slight excess over the debt limit will not have direct and significant negative effects on the country's economic position. However, implementing the policy of relatively high fiscal deficits in the following years with the possibility of realizing a moderate economic growth – in medium term would bring a considerable growth of public debt above 45% of GDP, which could jeopardize the sustainability of the Serbia's public finances. Therefore, already in 2012 it is necessary to prepare a plan of a comprehensive fiscal consolidation, which will in the first place encompass a significant cutting of public spending in the following years and increase taxes. The necessary reduction of public spending is possible to achieve by decreasing the large expenditures items – wages in public sector, pensions, subsidies and the like, as well as through the introduction of revenue and expenditures of great (and increasing) number of extrabudgetary institutions into the Republic budget, which would increase the degree of control over the consumption, and it is possible that this would make room for the decrease/elimination of certain parafiscal charges. Similar measures of fiscal consolidation are implemented in other countries of the region, such as Poland, Rumania, Croatia and others, so their experience in this respect could be of use in devising the measures to be implemented in Serbia. In the aim of ensuring the sustainability of public finances, it is necessary to ensure already of 2013 a reduction of fiscal deficit by about 2 percentage points of GDP. Since the measures of fiscal consolidation would not have adverse effects on the economic environment, it is assessed as necessary to realize ¾ of targeted fiscal deficit reduction by cutting public spendings, and round ¼ by increasing taxes. Given that most significant categories of public expenditures are systematic in character, it is assessed that the adjustment effects on the expenditures side would be achieved gradually, while the adjustment on the side of revenue should be one-off.