6. Fiscal Flows and Policy

Viewed at the level of all three quarters of 2011, overall public revenue dropped faster than planned due to the deceleration of economic activity and reduction in macroeconomic tax basis –incomes and consumptionincome and consumption. At the same time, expenses rose nominally faster than planned, primarily because of relatively high inflation in Q1 which led to a high indexation of salaries and pensions. In 2011, a positive change was registered in the structure of public expenses through a reduction of current and a strong growth of capital expenditures. Since the level of capital expenditures continues to be relatively low, these trends in regard to changes in the structure of public spending need to be continued in the future. As a consequence of the described trends, the consolidated fiscal deficit in the first three quarters stood at around 108.8 billion Dinars (or about 4.4% of the GDP in the first three quarters of 2011). Assuming that similar trends will continue to the end of the year, the estimate is that the consolidated fiscal deficit will be around 4.5% of the GDP. Since the expected rate of economic growth in 2011 dropped from 3% to 2%, the rise of the fiscal deficit from 4.1% to 4.5% is in accordance with the fiscal rules. Serbia's public debt at the end of Q3 stood at 14.7 billion Euro (about 44.8% of the GDP) which is about 2.6 billion Euro more than at the end of 2010. Since the public debt at the end of Q3 drew close to the limit set by law of 45% of the GDP, it is necessary to look into additional measures to lower the fiscal deficit so that the legal limit of the size of the public debt would be exceeded minimally and for a short time.

General Trends and Macroeconomic Implications

Following the drop in Q2, public expenditures in Q3 are rising slightly again

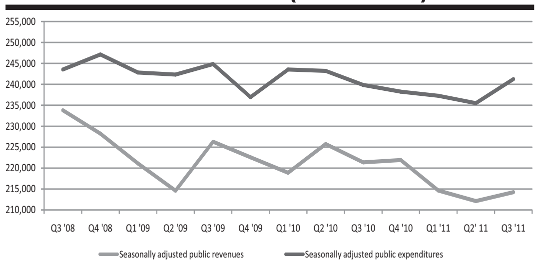
In Q2 the trend of real seasonally adjusted public revenue dropping continued and they were 1.2% lower compared to the previous quarter. That drop is the consequence primarily of a significant reduction in revenue from VAT and customs and other tax revenues. Although similar trends continued in July, positive trends in August and especially in September led to a slight rise in real seasonally adjusted public revenues in Q3 compared to Q2 (by 1%). The rise in public revenues in Q3 is the consequence of a moderate recovery of consumption taxes (VAT and duties) as well as a slight rise on tax revenue on production factors. In Q3, a drop was registered only in customs revenue. In the first three quarters of 2011, consolidated public revenue was lower by 4.4% compared to the same period of 2010 which is a significantly greater drop than planned (1.1%). The basic cause of the negative tendencies in public revenue trends are the unfavorable economic activity trends which deteriorated especially after the first quarter. In the first nine months of 2011, the GDP growth rate was lower than initially planned while the major macroeconomic tax bases – income and consumption – showed a real drop. Also, the drop in public revenue was partly caused by the rebalancing of the economy: basing economic growth on a rise in investments with lower spending. The drop in public revenue was also caused by the further liberalization of foreign trade and possibly the growing tax evasion.

…and public expenditures in Q3, after five quarters, are on the rise again

The real seasonally adjusted public expenditures of the consolidated government sector continue the downwards trend in Q2 and were 0.7% lower than in Q1 primarily thanks to the lowering of expenses in the purchase of goods and services and subsidies. Following the continued drop in five previous quarters (real seasonally adjusted) public spending in Q3 registered a growth compared to the previous quarter and were 2.4% higher compared to Q1. The rise in public spending in Q3 is the consequence of increased spending on salaries and pensions (due to the regular increase in May) and the significant growth of spending on subsidies and capital expenditures. Although the raise in salaries and pensions was done in Q2, the increase covered two months of Q2 and all three months of Q3 and a rise in expenses was registered in Q3 compared to Q2. The consolidated government expenditures in the first three quarters of 2011 were lower in real terms by 2.6% compared to the same period of 2010. The greatest contribution to the drop in overall public spending in 2011 came from the drop in expenditures for salaries and pensions due to the consistent implementation of fiscal rules which regulate the way they are indexed. Also, a positive assessment was made of the increase in capital expenditures, which were higher in real terms in the first three quarters of 2011 by 8% compared to the same period of previous year. The rise in capital spendings is with the rise of speeding up from quarter to quarter.

Consolidated fiscal deficit in first three quarters of 2011 stands at about 108.8 billion Dinars (4.4% of the GDP)

Graph T6-1. Serbia: seasonally adjusted real (quarterly) revenue and expenses in state sector in mil. RSD (2006=100)[1]

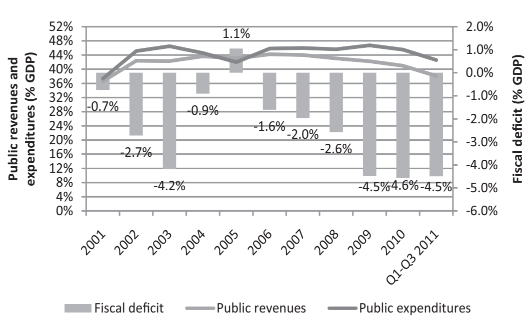


Source: Author`s calculations

1 Since the RZS stopped publishing retail price indices as of December 2010, this issue of QM uses the base retail consumer price indices (2006=100) to calculate nominal into real revenues and expenses to calculate seasonally adjusted amounts.(2006=100).

As a result of those trends, the consolidated deficit in the first three quarters of 2011 stood at 108.8 billion Dinars which is approximately 4.4% of the GDP in that period. Starting from the achieved fiscal deficit in that period and the fact that the fiscal deficit is especially high in the last quarter because of the seasonal effect, that the growth of the GDP is decelerating and the planned annual deficit for 2011 and the appropriate amounts in previous years, the estimate is that the consolidated fiscal deficit for 2011 will exceed the planned 141.2 billion Dinars (4.1% of the GDP). The rise in the deficit above the initially planned level will be achieved primarily because of the significant drop in public revenues, caused by a deceleration of economic activity and because of the adoption of changes to the Law on Financing Local Self-governments which gives an additional 40% of wage tax revenues to municipalities and cities without an adequate decentralization of competencies and jurisdiction. The negative trends in public revenues were influenced by the further liberalization of foreign trade and possibly the rising level of tax evasion. The fiscal rule on determining the target fiscal deficit is presented in the formula, with the level of deficit in the current year depending, among other things, on the GDP growth rate in the current year. Since the expected GDP growth rate in 2011 was revised from 3% to 2%, which is thought to be justified and possibly slightly optimistic, it is assessed that the fiscal deficit of 4.5% of the GDP in 2011 is in accordance with the fiscal rules. The increase of the fiscal deficit from 4.1% to 4.5% of the GDP, when economic activity is decelerating is justified, since a more restrictive fiscal policy (through raising taxes or cutting public spendings) would have an additional negative effect on economic activity.

Graph T 6-2. Serbia: public revenue, public expenses, fiscal deficit (% of GDP)



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

Late in August, the Serbian government contracted an stand-by arrangement with the IMF. The accompanying Memorandum allowed for an increase in the fiscal deficit in 2011 from 141.2 to 154.3 billion Dinars. Namely, the Memorandum stated that the overall public revenue in 2011 can be lower by 11.7 billion Dinars in regard to the initial plan primarily due to a drastic drop in revenue from VAT as a consequence of the negative trends in economic activity. On the other hand, it has allowed for the overall expenditures to increase by 1.4 billion Dinars compared to the initial plan as the net result of a significant nominal rise in expenses for pensions and salaries (due to the high indexation in May as the consequence of the high inflation rate) and significant savings in expenditures for goods and services, interest and capital expenses (the plan was for capital expenses to be lowered at central level and increased at local level and for capital expenses to be financed from loans). Starting from the trends in the first nine months of 2011 – the estimate is that the indicated plan which includes significant savings on expenditures on goods and services and a planned slight rise in revenue from excise duties is moderately optimistic. The assessment is that if the existing trends continued they would lead to a rise in the fiscal deficit by seven or eight billion (0.2–0.25% GDP) over the planned 154.3 billion Dinars (4.5% of the GDP). The assessment is that the planned deficit can be achieved only through an exceptionally restrictive implementation of public spending policy and greater efforts to increase the collection of public revenues.

Table T6-3 Serbia: consolidated balance of state sector[1], 2008-2009-2010-2011

	2008	2009	2010					2011			
			Q1	Q2	Q3	Q4	Q1-Q4	Q1	Q2	Q3	Q1-Q3
I TOTAL REVENUE	1145.9	1,147	266.6	292.9	309.5	354.4	1,223.4	293.6	311.3	331.8	936.7
II TOTAL EXPENDITURE	-1195.7	-1247.9	-286.1	-317.8	-329.7	-396.3	-1,329.9	-314.4	-343.9	-367.1	-1025.4
III "OLD" DEBT REPAYMENT, NET LENDING AND RECAPITALIZATIONS	-19.1	-20.4	-4.6	-6.4	-8.5	-10.4	-29.9	-5.5	-9.9	-4.8	-20.2
o/w Net lending [2]	-19.1	-20.4	-4.6	-6.4	-8.5	-10.4	-29.9	-5.5	-9.9	-4.8	-20.2
IV TOTAL EXPENDITURE, GFS (II+III)	-1214.8	-1268.3	-290.7	-324.2	-338.2	-406.7	-1,359.8	-319.9	-353.8	-371.9	-1045.5
V CONSOLIDATED BALANCE (I+IV), GFS definition[3]	-68.9	-121.8	-24.1	-31.2	-28.8	-52.3	-136.4	-26.3	-42.4	-40.1	-108.8
VI ACCOUNT BALANCE CHANGE	-55.4	45.4	-2.3	-8.4	0.9	-9.4	-19.2	33.1	9.4	56.2	98.7
VIII TOTAL REVENUE/GDP (%)	41.7	42.3	41.0	40.3	40.5	45.2	41.8	38.7	36.8	39.0	38.1
IX TOTAL EXPENDITURE/GDP (%)	(45.6)	(46.7)	(44.7)	(44.6)	(44.3)	(51.8)	(46.5)	(42.1)	(41.8)	(43.7)	(42.6)
X CONSOLIDATED DEFICIT/GDP (%)	(3.9)	(4.5)	(3.7)	(4.3)	(3.8)	(6.7)	(4.7)	(3.5)	(5.0)	(4.7)	(4.4)

Source: Table P-10 in Analytical annex
1) State sector (general government) – all levels of power (republic, province, municipality) and their budget beneficiaries and organizations for mandatory social security (pension and insurance funds, Republic Health Care Authority, National Employment Service). Does not include public companies and NBS.
2) This is equal to the Expenses for Purchase of Financial Assets in PFB, that is net lending in the IMF presentation. This is about loans to students, farmers, loans through the Development Fund and repayment of debts to pensioners and recapitalization.
3) The consolidated balance (cash surplus/deficit under GFS) is the difference between current revenue and income from the sale of non-financial assets (that is capital revenue) and current expenses for the purchase of non-financial assets (that is capital spending). Also, the expenses include the repayment of domestic debts – pensions, budget loans and recapitalization. Results defined in this way are the measure of the liquidity effect which state transactions have on the economy. See methodology discussion in Framework 1 in Quarterly Monitor No. 3 for details.

Drop in budget revenue registered in October due to redistribution of revenue from wage tax

State budget revenue in October 2011 was lower in real terms by 1.3% compared to the same month a year earlier. The major reason of such decline in public revenues is a decrease in revenues from personal income tax by 50.4% compared to October 2010, which happened because of the start of the implementation of the Law on Financing Local Self-governments on October 1. That led to a decrease in the participation of the state budget in wage tax revenue from 60% to 20% (and in the province of Vojvodina to just 2%). At the same time, revenues from consumption taxes (excise duties and VAT) saw a significant real rise (5% and 27.6% respectively) compared to October 2010, which sindicates high volatility great in their movement. Revenues from other taxes (corporate income tax, customs duties, etc) continued their real decline. State budget spending in October 2011 was 6.4% lower in real terms than in the same month of previous year. That drop is the consequence primarily of a lower spending on subsidies and transfers to other levels of government. The positive trend of the growth of capital spending continued in October. The budget deficit in October was 11.6 billion Dinars and is close to the average monthly budget deficit in the first three quarters of 2011 (around 10.8 billion Dinars). The overall deficit of the budget in the January-October 2011 period are 108.7 billion Dinars. Starting from the overall planned deficit for the state budget for 2011, and the monthly speed in this period, as well as the trends in November, the estimate is that there is a possibility the state budget deficit in 2011 could stay within the planned framework if similar trends continue and assuming that the planned savings are strictly implemented (including savings on expensditures financed from own revenues).

Frame 1. Fiscal effects of adopted changes to the Law on Financing Local Self-governments

The Parliament of Serbia adopted amendments to the Law on Financing Local Self-governments in June. According to these amendments, the distribution of wage tax revenue between local communities and the Republic is to change, so that the participation of local communities is to increase from 40% to 80%, with a slight reduction of the transfers to the most developed municipalities and cities. The transfer of 40% of the wage tax revenues from the budget of the Republic to the local self-government budgets will result in a drop in revenue pf the Republic budget by approximately 42 billion Dinars (about 1.4% of the GDP), while the proposed decrease in the transfers to the most developed municipalities would lead to a reduction in the overall transfers by approximately eight billion Dinars (0.3% of the GDP). Without a significant further decentralization on the side of public spending, these changes to the Law on Financing Local Self-governments would lead to a rise in the fiscal deficit in 2012 by approximately 35-40 billion Dinars. Preliminary plans for 2012 show that the planned savings at the central level of six to seven billion Dinars refer to withdrawal of the Republic from (co)financing of local projects. The saving of approximately 10 billion Dinars based on cut in transfers from the budget of the Republic for maintenance of local roads to local governments, is planned. The remaining gap of about 20 billion Dinars will be covered through ad hoc measures, such as revenue from dividends, fees, penalties, duties and various one-off savings. However, since the change of the manner of distribution of wage tax revenues is permanent, systematic measures have to be established (for example further transfer of competencies from central to local level) which would provide for reduction of the remaining gap or its financing in coming years. An analysis needs to be done to determine which central government functions can be transferred to the local level and what kind of decentralization on the expenditure side needs to be implemented.

If the risk of the world economy falling into recession comes true and the inevitable negative effects on the economy of Serbia arise, there would be a further drop in public revenue (as was the case in 2009). Also, the implementation of the changes to the Law on Financing Local Self-governments started in 2011 and will lead to an increase of the fiscal deficit. Starting from the negative tendencies in regard to trends in public revenues and the mentioned potential negative effects of exogenous (the world economic crisis) and endogenous factors (changes to the system of financing local government and the indexing of salaries and pensions in accordance with the fiscal rules) – it is our estimate that in order to secure the sustainability of public finances, Serbia needs to achieve significant savings on the side of expenses in the coming period (for example by re-defining the system of subsidies where certain savings have been made at central level but not at local level) and promoting the efficiency in collecting public revenues (primarily VAT and labor taxes). Since inflation was relatively low in Q2 and Q3, we can expect the nominal rise of salaries and pensions in October, due to regular indexation, to be relatively low which will have a positive effect on trends in those categories of public expenses. The current change of the rules of indexing salaries and pensions with the aim of further limiting their growth, will be hard to implement primarily for political reasons. On the other hand, the announced activities by the Tax Authority aimed at controlling the issuance of fiscal receipts in retail shops, restaurants and hotels is a positive step. However, in order to improve the collection of tax revenues certain systematic measures are required (continued increase in the frequency of controls of taxpayers, raising and change the penalty rates, changing the way labor taxes are reported and paid, exchanging information between different state bodies, etc). Considering the negative trends in economic activity, it will be necessary for the fiscal deficit to drop faster than predicted by fiscal rules to avoid a significant rise in the public debt.

Analysis of certain tax forms and individual public expenses

Following negative trends in Q2, revenue from VAT and excise duties rise moderately in Q3

In Q2 the real seasonally adjusted revenues from VAT and customs duties registered a drop compared to the previous quarter and revenue from excise duties saw a slight rise. However, in Q3 there was a slight recovery in the revenues from consumption taxes, since the revenues VAT and excise duties rose moderately compared to the previous quarter (by 2.5% and 2% respectively), while the drop in revenue from customs duties eased (4.1%). Although there was an easing of the y-o-y rate of drop in real terms in Q3, revenue from VAT and customs duties in the first three quarters of 2011 dropped in real terms (compared to the same period a year earlier) faster than planned, while the rise in the revenue from excise duties was lower than planned. The continued strong drop in revenue from customs duties is the consequence of lower imports and the real appreciation of the Dinar against the Euro, which had an added effect on the lowering of the base for calculation of customs duties. The real seasonally adjusted revenue from VAT in

Q2 saw a drop for the third quarter in a row (2.9%) compared to the previous quarter, while a rise was registered in Q3 (2.5%) compared to the previous quarter. Although the initial plan was for revenue from VAT in 2011 to be higher in real terms by about 1.7% compared to 2010, VAT revenues in the first three quarters of 2011 were lower in real terms by 5.8% compared to the same period of the previous year. The drop in VAT revenues is the consequence of lower personal consumption and the change in its structure, so that the subsistence spending and spending on base products taxable at the lower VAT rate of 8% has increased. The Republic Statistics Office does not monitor personal consumption trends at quarterly level, but only turnover in the retail trade, which in the January-September 2011 period dropped in real terms by 16.9% compared to the same period a year earlier. However, since retail turnover does not include a significant part of household consumption (electricity, communal services, education, health care, etc) which is to a great extent inelastic (in terms of price and income), it is our estimate that the retail turnover does not represent an adequate indicator of personal consumption and that in crisis period it tends to overestimate the drop in personal consumption. In that regard, starting from the fact that about 85% of personal consumption in Serbia is financed from salaries and pensions, the movement of the overall amount of salaries and pensions is an appropriate approximate indicator of personal consumption. Since the real fund for salaries and real fund for pensions dropped by 5-6% in the first three quarters of 2011, while no recovery in borrowing to individuals has been registered, personal consumption in Serbia is estimated to have dropped by the same amount in that period which is close to the drop in real terms of VAT revenue. The conclusion is that the drop in VAT revenue in the Q1-Q3 period of 2011 is the consequence of a drop in basic macroeconomic bases – income and consumption. Since the trend of a lower participation of personal spending in the GDP started in 2009 and that it is the consequence of a drop in the real income of the population, a re-balancing of the economy and liberalization of foreign trade, these VAT revenue trends are expected to continue in the coming period. After growth deceleration in Q2, the real seasonally adjusted revenue from excise duties in Q3 registered a moderate rise (of 2.5%) compared to the previous quarter which was influenced, among other things, by the rise in excise duties on oil derivatives in June (with the aim of harmonizing excise duties policies with the Stabilization and Association Agreement). Although revenue from excise duties in the Q1-Q3 period of 2011 rose in real terms by 3.3% compared to the same period previous year, that growth is slower compared to the planned growth rate for 2011, which was initially estimated at 7.6%. The main reason for the negative tendency compared to the planned growth rate for excise duties revenue lies in the unrealistic initial planning for that revenue. Also, the slower rise in duties revenue than planned can be the consequence of lower consumption of products subject to excise duties, changes in the structure of consumption, in the sense of a rise in the participation of cheaper product and a possible rising level of tax evasion and cross-border arbitrage, especially in the border area with the Republika Srpska.

Table T6-4 Serbia: Seasonally adjusted quarterly index of 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	97.9	122.8	93.2	93.5	95.6	88.0	93.1	93.9
2009,Q2	97.1	93.2	103.2	86.3	96.0	99.5	86.9	99.1	96.5
2009,Q3	105.4	107.6	104.0	94.5	100.6	99.7	105.1	121.9	117.9
2009,Q4	98.4	103.1	101.0	98.5	95.6	95.6	93.8	101.7	88.5
2010,Q1	98.3	95.5	100.6	97.0	104.5	103.0	105.0	101.5	102.4
2010,Q2	103.1	103.4	102.9	101.7	98.6	97.6	99.5	110.9	110.8
2010,Q3	98.1	100.9	101.1	94.6	97.9	96.6	98.0	92.2	94.4
2010,Q4	100.3	96.1	100.2	93.0	99.0	98.5	103.6	99.6	108.6
2011,Q1	96.7	97.9	101.7	94.7	97.6	99.9	101.7	92.1	88.6
2011,Q2	98.8	97.1	100.6	90.9	102.0	99.8	101.8	93.1	102.4
2011,Q3	101.0	102.5	102.0	95.9	100.9	100.8	101.5	103.9	101.2
Index in 2011, Q3 (2009,Q1=100)	96.9	96.4	118.8	57.6	92.6	91.1	95.5	113.1	107.6

Source: *QM* calculation

...while revenues from taxes on production factors mainly rose

The real seasonally adjusted revenues from personal income tax in Q2 was higher in real terms by 2% compared to Q1, which is the consequence of the growth of the average salary (primarily because of the increase of salaries for public sector employees in May 2011 and higher amount of salaries paid to employees in the public education system in June, to compensate for classes lost during last year's strike). However, revenue from social security contributions in Q2 dropped slightly compared to Q1, so the divergent trends of income tax and social contributions revenue has continued, although they are mostly calculated on the same base. That could be the consequence of a drop in fiscal discipline among employers and/or a significant rise in those types of personal incomes which are not subject to social contributions (capital income, real estate rental, capital gains and similar). It is evident that a growing number of employers are reporting the full amount of taxes and contributions to the Tax Authorities, but are not paying them because of liquidity problems. Although that increases the probability of detection by the Tax Authority it reduces the expected fine, because this is not tax evasion but failure to pay taxes. The real seasonally adjusted revenue from personal income tax and social contributions in Q3 grew in real terms by 0.9% and 0.8% respectively compared to Q2 which is explained with the effect of increased public sector salaries in May, covering just two months of the second quarter and all three months of the third quarter of 2011. Viewed in regard to the same period of 2010, revenues from personal income tax and social contributions in Q1–Q3 2011 dropped in real terms by 3.9% and 4.8% respectively, which is a greater drop than planned and represents the consequence of a reduction of the real wage bill due to a drop in (formal) employment and earnings. Although the government adopted a decree in June officially reducing the fiscal burden on salaries for new employees over a period of one year, to motivate employers to register their employees, the results in the first two months of implementation were modest. The main reasons for the lack of significant effects on increasing employment is the time limited fiscal relief on wages and lack of increase in the probability of discovering unregistered employees through frequent, rigorous and comprehensive control by the Tax Authority.

The real seasonally adjusted revenue from corporate income tax in Q2 was 1.8% higher than in Q1 and similar results were recorded in Q3, when revenue from this tax rose by 1.5% over the previous quarter. Revenue from corporate income tax in the first three quarters of 2011 were 6.1% higher comparing to the same period of previous year. Those trends are the result of the improved profitability of the economy and the abolishing of certain tax exemptions, such as the tax credit for new employees. However, in 2012 we cannot expect those trends to continue because of the fact that the lifting of the tax exemptions can have only one-off effect.

In Q2 a significant drop was registered in other (real seasonally adjusted) tax revenue of 6.9% comparing to the previous quarter, while in Q3, for the first time after four quarters, their growth was registered (of 3.9% in comparison to the previous quarter). At the same time, in Q2 and Q3, a rise was registered in real seasonally adjusted non-tax revenues (by 2.4% and 2.1% respectively, comparing to the previous quarter).

Table T 6-5. Serbia: Seasonally adjusted quarterly indices of real level of public expenses (previous quarter = 100)

	Public expenditures	Staff expenditures	Purchase of goods and services	Subsidies	Pensions	Capital expenditures
2009,Q1	98.3	95.7	99.3	80.8	103.3	85.5
2009,Q2	99.8	99.6	104.0	95.1	99.1	121.4
2009,Q3	101.0	99.4	97.1	106.9	100.8	85.5
2009,Q4	96.8	101.3	97.0	84.2	99.7	91.9
2010,Q1	102.8	98.8	106.4	118.4	98.7	118.3
2010,Q2	99.9	97.4	97.5	120.4	97.9	93.6
2010,Q3	98.6	99.2	99.5	92.2	98.7	106.8
2010,Q4	99.3	97.0	98.3	94.8	97.7	100.9
2011,Q1	99.6	100.4	103.6	108.2	96.1	102.1
2011,Q2	99.3	101.7	95.3	86.0	102.6	101.0
2011,Q3	102.4	102.0	97.2	132.1	102.2	120.3
Index in 2011, Q3 (2009,Q1=100)	99.3	96.5	95.3	131.2	93.5	141.2

Source: *QM* calculation

In Q2 and Q3 spendings on employees and pensions rose

Real seasonally adjusted expenditures on salaries in the public sector and pensions in Q2 were 1.7% and 2.6% higher respectively, compared to the previous quarter, which is the consequence of regular indexation. Namely, in April 2011, under the rules defined by the Law on the Budget System, salaries in the public sector and pensions were nominally raised by 5.5%. The rise of the expenditures for salaries and pensions over the previous quarter was registered in Q3 as well (by

2% and 2.2% respectively). Since there were no changes in Q3 to the nominal level of salaries in the public sector and pensions, the rise of expenditures for that purpose in Q3 over Q2 is the consequence of the fact that the increase in salaries and pensions was done in May (and covered two months of the second quarter) while in Q3 that effect covered all three months. In regard to the same period of the previous year, expenditures for salaries and pensions in the first three quarters of the current year are lower in real terms by 2.4% and 5.6% respectively. Although the increase of salaries and pensions in 2011 was done in the same manner, the drop in expenditures for salaries in the public sector is lower than the drop of pensions, which is explained with the extra payments of salaries and other dues to employees in parts of the public sector which have significant own revenues and for employees in public companies. Since the expected GDP growth rate in 2011 is lower than 2%, we can expect that, besides the indexation in April and October, the trend of a relative reduction of these categories of public spending will continue, because the indexation will be done only at the rate of inflation. Since these are large items of total public spendings, adhering to fiscal rules which determine the mechanism of their indexation in the pre-election period, or possibly an increase in the restrictiveness of these rules if the world economic crisis escalates, are the key conditions to secure the sustanabilitysustainability of public finance system in Serbia.

The real seasonally adjusted expenses for subsidies registered a drop of 14% in Q2 over Q1, while in Q3 they rose in real terms by 32.1% over Q2. There are great non-seasonal oscillations in the trends for expenditures on subsidies, which is the consequence of the fact that the subsidy policy is not systemic in character, but depends on discretionary measures. A significant drop in expenses for subsidies in Q2 over Q1 is the consequence of the fact that in Q1 a large single payment of subsidies was paid to the Serbian Railways, which raised the base for comparison in Q2. Overall expenses on subsidies in the Q1–Q3 period of 2011 are higher in real terms by 1.1% over the same period of 2010. However, a comparison of the dynamics of expenditures for subsidies in the first three quarters of 2011 and 2010 shows that the implementation of these categories of expenses in the first three quarters of 2011 was about equal, which leads to the conclusion that the trends in these expenditures are in accord with plans.

Table T6-6. Serbia: consolidated balance of state sector[1], 2007-2008-2009-2010-2011

	2007	2008	2009	2010					2011			
				Q1	Q2	Q3	Q4	Q1-Q4	Q1	Q2	Q3	Q1-Q3
I PUBLIC REVENUES	1,002.0	1,145.9	1,146.5	266.6	292.9	309.5	354.4	1,223.4	293.6	311.3	331.8	936.7
1. Current revenues	995.4	1,143.1	1,139.2	266.2	292.4	308.9	348.1	1,215.7	292.9	310.5	331.2	934.6
Tax revenue	870.0	1,000.4	1,000.3	236.1	255.6	269.3	295.5	1,056.5	259.1	272.0	287.3	818.4
Personal income taxes	115.8	136.5	133.5	31.1	34.5	34.4	39.0	139.1	32.7	37.9	37.9	108.5
Corporate income taxes	29.7	39.0	31.2	11.7	6.5	6.5	7.9	32.6	14.4	7.5	7.6	29.5
VAT and retail sales tax[2]	265.5	301.7	296.9	71.9	77.3	83.2	87.0	319.4	79.3	80.9	86.6	246.8
Excises	98.6	110.1	134.8	27.2	35.1	42.5	47.4	152.2	35.1	40.2	46.9	122.1
Custom duties	57.4	64.8	48.0	9.5	11.0	11.3	12.5	44.3	9.0	9.5	9.7	28.2
Social contributions[3]	270.3	312.7	318.8	74.9	79.4	79.8	88.9	323.0	78.3	85.6	87.4	251.3
Other taxes	32.8	35.6	37.1	9.8	11.8	11.5	12.9	46.0	10.2	10.5	11.4	32.1
Non-tax revenue	125.4	142.7	138.8	30.2	36.8	39.6	52.7	159.2	33.8	38.5	43.9	116.2
2. Capital revenues	5.3	1.4	0.9	0.0	0.2	0.0	0.1	0.3	0.3	0.3	0.3	0.9
II TOTAL EXPENDITURE	-1,031.5	-1,195.7	-1,248	-286.1	-317.8	-329.7	-396.3	-1,329.9	-314	-343.9	-367.1	-1,025.4
1. Current expenditures	-919.5	-1,089.6	-1,155	-272.6	-300.5	-304.0	-347.7	-1,224.8	-298	-323.9	-334.6	-956.6
Wages and salaries	-238.3	-293.2	-302.0	-72.7	-76.0	-76.3	-83.1	-308.1	-76.7	-85.3	-85.7	-247.7
Expenditure on goods and services	-237.4	-139.9	-187.4	-39.7				-39.7	-44.7	-52.6	-51.0	-148.2
Interest payment	-168.1	-181.2	-187.4	-39.7	-47.9	-49.0	-65.9	-202.5	-9.9	-12.1	-11.1	-33.1
Subsidies	-17.9	-17.2	-22.4	-8.0	-8.3	-8.2	-9.7	-34.2	-15.1	-15.4	-28.4	-58.9
Social transfers	-63.7	-77.8	-63.1	-11.2	-18.4	-22.1	-26.2	-77.9	-142.6	-150.4	-151.7	-444.8
o/w: pensions[5]	-409.3	-496.8	-556.4	-137.1	-144.0	-142.3	-155.7	-579.2	-99.2	-105.4	-107.0	-311.6
Other current expenditures	-259.9	-331.0	-387.3	-97.1	-97.5	-98.2	-101.3	-394.0	-9.1	-8.2	-6.6	-23.9
2. Capital expenditures	-22.1	-23.5	-24.0	-3.9	-5.9	-6.1	-7.0	-22.9	-16.3	-19.9	-32.6	-68.8
III "OLD" DEBT REPAYMENT, GOVERNMENT NET LENDING AND RECAPITALIZATIONS	-15.3	-19.1	-20	-4.6	-6.4	-8.5	-10.4	-29.9	-5	-9.9	-4.8	-20.2
IV TOTAL EXPENDITURE, GFS (II+III)	-1,046.8	-1,214.8	-1,268.3	-290.7	-324.2	-338.2	-406.7	-1,359.8	-319.9	-353.8	-371.9	-1,045.5

Source: Table P-6 in Analytical annex.
1) See footnote 1) in Table T7-1.
2) Turnover tax/VAT lowered by new tax loans to economy.
3) Contributions lowered by compensation between Pension Fund (PIO), Development Fund and companies owing PIO Fund.
4) FREN assessment. See table P-10 in Analytical annex for explanation.
5) Covers only expenses for current pensions.
Note:
Real growth achieved by implementing average base index for retail prices (base December 2003) on quarterly data.

The real seasonally adjusted expenses for the purchase of goods and services in Q2 were lower by 4.7% over Q1, which is explained in part by the unplanned payment of satellite rental to an

Expenditures on goods and services are dropping...

Israeli provider performed in Q1, raising the base for comparison in Q2. The trend of a real drop in expenditures for this purpose continued in Q3, when a drop of 2.8% was registered compared to the previous quarter. Savings on expenditures for goods and services are in accordance with the plans under which the consolidation of expenditure side of public finance by the end of 2011 will be to large extent performed through cut in these expenses. That requires a systemic approach, which would be aimed at lowering wastefulness, irrationality and possible abuses in spending those funds, without endangering the normal functioning of the public sector or preventing arrears.

...while capital expenditures rise sharply

Capital expenditures in Q2 and Q3 registered growth over the previous quarter, which continues the trend started in Q3 2010, with that rise being pronounced in Q3 2011 when the real seasonally adjusted capital expenditures were higher by 20.3% compared to Q2. In the first three quarters of 2011, capital expenditures rose in real terms by 8% over the same period of 2010, while current expenditures dropped in real terms by 3.3%. That restructuring of public spending is the consequence of a accelerated implementation of investment projects and is seen as positive and desirable. Despite that, capital expenditures stand at just about 3.5% of the GDP, which is significantly lower than the required level of public investments in the country tending to build and upgrade its infrastructure, which is estimated at about 5% of GDP. Also, the fact that capital expenditures are about 1 percentage point of GDP lower than the fiscal deficit is viewed as especially unfavorable, which means that the state debt of 1 percentage point of GDP per year is used for current spending, puts the burden of public debt to future generations.

Table T6-7. Serbia: y-o-y real trends of consolidated balance of state sector1), 2007-2008-2009-2010-2011

	2007	2008	2009	2010					2011				
	Q1-Q4	Q1-Q4	Q1 - Q4	Q1	Q2	Q3	Q4	Q1 - Q4	Q1	Q2	Q3	Q1 - Q3	Q3/Q2
I PUBLIC REVENUES	8.6	3.3	-8.7	-4.0	2.5	-3.6	-1.3	-1.5	-2.8	-6.6	-3.6	-4.4	7.1
1. Current revenues	7.9	3.5	-9.1	-4.0	2.6	-3.5	-1.4	-1.5	-2.9	-6.7	-3.6	-4.5	7.2
Tax revenue	8.0	3.7	-8.8	-4.3	0.7	-3.0	-3.7	-2.5	-3.1	-6.5	-4.1	-4.6	6.2
Personal income taxes	-8.4	6.3	-10.8	-6.0	-3.8	-5.1	-1.2	-3.9	-7.2	-3.5	-1.1	-3.9	0.6
Corporate income taxes	52.1	18.5	-27.0	-15.2	7.5	-0.1	6.2	-3.6	9.2	1.5	4.8	6.1	2.7
VAT and retail sales tax 2)	10.6	2.5	-10.2	-3.5	6.4	1.1	-6.1	-0.7	-2.7	-7.9	-6.5	-5.8	7.5
Excises	6.5	0.7	11.6	3.9	6.8	2.4	3.4	4.2	13.7	0.7	-0.9	3.3	17.3
Custom duties	18.6	1.8	-32.4	-23.1	-11.9	-10.4	-14.8	-14.9	-15.9	-24.4	-23.1	-21.4	2.5
Social contributions 3)	9.6	4.3	-7.0	-4.9	-6.9	-8.8	-5.5	-6.5	-7.8	-5.3	-1.6	-4.8	2.6
Other taxes	1.7	-2.3	-4.9	23.3	36.8	3.9	2.1	14.5	-7.4	-22.1	-11.5	-14.1	8.9
Non-tax revenue	7.4	2.6	-11.3	-1.6	18.1	-6.7	13.4	5.8	-1.0	-8.1	-0.5	-3.3	14.6
2. Capital revenues	1,703.2	-76.8	-41.4	-97.6	-64.3	-26.0	69.6	-66.8	3330.6	47.9	746.3	225.7	-23.6
II TOTAL EXPENDITURE	8.9	4.5	-4.8	-1.4	-3.1	-3.2	0.3	-1.7	-3.0	-4.9	0.1	-2.6	7.3
1. Current expenditures	6.9	6.9	-3.3	-1.9	-2.0	-3.7	-1.4	-2.2	-3.5	-5.2	-1.1	-3.3	3.8
Wages and salaries	9.4	10.9	-6.0	-3.7	-6.1	-4.4	-8.9	-5.9	-6.9	-1.4	1.0	-2.4	1.1
Expenditure on goods and services	10.5		-5.7	3.1	-5.1		2.2	-0.3	-0.7	-3.6	-6.5	-3.8	-2.5
Interest payment	16.1	-2.8	-5.7	3.1	-5.1	-1.9	2.2	-0.3	9.9	27.4	22.8	20.2	-7.2
Subsidies	-44.4	-13.3	19.0	29.1	71.1	5.8	75.0	40.6	19.2	-26.1	15.3	1.1	84.7
Social transfers	7.6	10.1	-26.0	-5.3	16.6	9.2	26.8	13.9	-8.2	-8.2	-4.2	-6.9	1.4
o/w: pensions 5)	6.5	9.5	2.2	-3.8	-3.3	-5.5	-3.3	-3.9	-9.8	-5.0	-2.0	-5.6	2.1
Other current expenditures	7.1	14.9	6.7	-4.3	-5.6	-6.4	-7.9	-6.1	106.6	21.5	-2.8	33.2	-19.4
2. Capital expenditures	1.1	-4.3	-6.7	12.7	6.6	-18.1	-27.2	-11.8	6.3	1.4	13.9	8.0	64.3
III "OLD" DEBT REPAYMENT, GOVERNMENT NET LENDING AND RECAPITALIZATIONS	-53.9	12.3	-2.4	360.3	-4.9	34.9	27.7	35.2	6.3	35.7	-49.7	-8.3	-51.6
IV TOTAL EXPENDITURE, GFS (II+III)	9.2	4.6	-4.8	-0.1	-3.1	-2.5	0.8	-1.1	-2.9	-4.1	-1.2	-2.7	5.7

Source: Table P-6 in Analytical annex.
1) See footnote 1) in Table T7-1.
2) Turnover tax/VAT lowered by new tax loans to economy.
3) Contributions lowered by compensation between Pension Fund (PIO), Development Fund and companies owing PIO Fund.
4) FREN assessment. See table P-6 in Analytical annex for explanation.
5) Covers only expenses for current pensions.
Note:
Real growth achieved by implementing average base index for retail prices (base December 2003) on quarterly data.

Analysis of public debt trends

Serbia's public debt grew in Q2 and Q3 by about two billion Euro (to 44.8% of GDP)

At the end of Q3 2011, Serbia's overall public debt stood at 14.7 billion Euro (44.8% of the GDP[1]), which is about two billion Euro more than at the end of Q1. Compared to the end of 2010, the public debt grew by 2.6 billion Euro which is significantly higher than the consolidated fiscal deficit in the same period, which stood at about a billion Euro. That difference came because of the fact that the state tried in the first half of the year to provide funds to finance the deficit in the coming quarters and to pay existing state liabilities, which fall due soon and to secure the liquidity of the budget since a significant time is required to complete the debt

1 *QM* estimates.

procedure alone. As a consequence of the debt at an amount greatly higher than the total of the fiscal deficit in the first three quarters of 2011, net state deposits were formed at the end of September totaling about 1.5 billion Euro, which secured the liquidity of the budget, that is the financing of the fiscal deficit in the last quarter of the current year and the first half of 2012. Since the first half of 2012 is a (pre)election period, when the possibility of taking loans with a decision by parliament are limited, the securing of medium term liquidity of the budget in advance is viewed as correct. Besides that, the public debt crisis in the countries of the Euro zone caused a deterioration of general conditions for borrowing on the world financial markets, so that a loan now would probably come under the worse conditions. However, since this is a significant amount of deposits, it is necessary to secure the efficient management of those funds so that the cost of securing funds in advance would be as low as possible. Due to the fact that the new borrowoings in Q1-Q3 2011 exceed the respective fiscal deficit, the public debt at the end of Q3 was just 0.2 percentage points of GDP lower than the limits set by the fiscal rules. There is a great probability that the public debt in the coming period could exceed the limit of 45% of GDP, primarily due to great deceleration of economic growth in 2011 and expected further deceleration in 2012. Since there will be no extensive borrowing in the coming quarters (because the funds are provided in advance), the existing level of debt, does not endanger the financial stability of the country, if fiscal rules are obeyed in the forthcoming years (and to make fiscal deficit lower than the limits set by fiscal rules, if possible). If the fiscal deficit becomes higher than planned (allowed by fiscal rules), that can have a negative effect on sustainability of Serbia's public finance.

Table T6-8 Serbia: Public debt[1)] 2000-2011.

	Amount at the end of period, in billions EUR									
	Q4 2000	Q4 2005	Q4 2006	Q4 2007	Q4 2008	Q4 2009	Q4 2010	Q1 2011	Q2 2011	Q3 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
Domestic debt	4.11	4.26	3.84	3.41	3.16	4.05	4.57	5.30	5.64	5.65
Foreign debt	10.06	5.36	4.75	4.62	4.69	4.41	5.89	5.72	5.94	6.98
II. Indirect debt	-	0.66	0.80	0.85	0.93	1.39	1.71	1.68	1.71	2.12
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**
Public debt / GDP[2]	**169.3%**	**50.2%**	**36.2%**	**29.4%**	**25.6%**	**31.3%**	**41.5%**	**39.8%**	**40.6%**	**44,4%**
Public debt / GDP (QM)[3]	**135.3%**	**48.9%**	**35.7%**	**30.0%**	**29.8%**	**32.9%**	**41.0%**	**41.2%**	**41.7%**	**44.8%**

1) Under the law on public debt, that debt includes the debt of the state under contract signed by the state on the basis of stocks and bonds, contracts and agreements which reprogrammed the dues that the republic accepted earlier under contracts and the issuing of bonds under special laws, the debt of the state under guarantees of the republic or on the basis of accepting obligations as a debtor for the payment of debts under those guarantees, that is on the basis of counter-guarantees by the republic, the debt of the local government who received state guarantees.
2) Estimate by Serbian Finance Ministry
3) QM estimate (using quadruple quarterly value of GDP after the elimination of the components of season and cycle, the implementation of the Hodrick-Prescott filter.)
Source: Data from Serbian Finance Ministry and QM estimates

Of the 14.7 billion Euro of public debt – approximately 12.6 billion Euro refers to direct liability and 2.1 billion Euro refers to indirect liability. By comparing data on the extent and structure of the public debt at the end of Q1 and at the end of Q3 2011, we can conclude that the rise of the public debt in Q2 and Q3 mostly refers to rise in direct debt. Also, in Q2 there was a strong rise of the internal (direct) debt, due to the issue of T-bills in the domestic financial market, while in Q3 the amount of foreign direct dues rose significantly which is the consequence of the issuance of Eurobonds (while in Q3 the internal debt on the basis of T-bills stagnated).

The indirect debts of the state rose in Q2 and Q3 over the end of Q1 by about 400 million Euro and were made on the basis of guarantees issued by the state for loans taken by public companies.

Potential liability on the basis of denationalization will be about 5–6% of GDP

The fiscal rules state that the general government debt (without the restitution debt) cannot exceed 45% of GDP. In September 2011 the Serbian Parliament adopted a Law on the Restitution of Seized Property and Compensation, , which regulates the question of restitution for the heirs of owners of property nationalized after World War II. That Law provides for restitution in kind, that is the return of property wherever possible, and financial compensation in case when restitution in kind is not possible. The Law states that the overall amount of financial compensation is two billion Euro (5–6% of GDP), and that those payments will start in 2015, after fresh records are made and the validity of all demands is verified. Since the payments of liability on the basis of old foreign currency saving deposits, which require about 250-300 million Euro a year, is due to end in 2016, the estimate is that, *ceteris paribus*, payments of liabilities on the basis of denationalization in an equivalent annual amount would not have a significant effect on the liquidity of the budget. That solution which limits the overall financial liability of the government and does not make that liability a direct function of overall amount of claims, is seen as correct in the context of securing long term sustainability of public finances in Serbia. The Law on the Budget System states that the public debt cannot exceed 45% of GDP, but that limit does not include the state obligations on denationalization grounds. Since the liability stemming from denationalization will trigger certain payments from the budget, it is necessary to take into account this liability as well in assessing sustainability of Serbia's public finance and creation of fiscal policy measures. If the overall rise of the public debt in Serbia on the basis of denationalization stands at 5-6% of GDP, the estimate is that this will not have significant effect on the long-term sustainability of public finances in Serbia, especially if a moderate or large growth of GDP is achieved in coming years. If that ratio of the public debt to GDP, due to the effects of external and internal factors (as mentioned earlier),significantly exceeds the amount set by fiscal rules and the GDP grows more slowly, those trends in combination with an increase of the public debt for denationalization could jeopardize sustainability of public finances in Serbia.

Frame 2. Issuance of Eurobonds by the Republic of Serbia

The first issuance of the Republic of Serbia's Eurobonds was in September 2011, to the value of one billion Dollars, with a due date of 10 years and an annual interest rate of 7.25%. The advantage of borrowing on the foreign financial market lies in the elimination of the possibility of crowding-out effect, which could happens in case of borrowing on the domestic financial market. Since a large part of institutional investors in Serbia provided funds to buy T-bills, by drawing money from their headquarters abroad and not from domestic savings, it is our estimate that the crowding-out effect from issuance of Dinar denominated T-bills on the domestic market would is not large, which is why the indirect benefits from the issue of Eurobonds are limited. On the other hand, the issuance of bonds in US Dollars increased the participation of the debt set in foreign currency, which affects the rise in the exchange rate risk. . Also, by comparing the offered interest rate of 7.25% with the real interest rate on bonds issued on the domestic market (about 5%), and an interest rate on loans from commercial banks (5–6%) – it is assessed that the conditions under which the Eurobonds were issued are relatively unfavorable. However, we should take into consideration the fact that in the meantime there has been a significant deterioration of the conditions for borrowing on the world financial market, because of the sovereign debt crisis in the Euro zone. At an auction on 24 November 2011, Germany, despite its top level credit rating, manage to sell only 2/3 of issued bonds, while the interest rate on long-term bonds issued by Slovenia rose from 4.9% to 7%. The conclusion is that a delay in taking loans for the coming period, instead of in September, would lead to the conditions becoming even more unfavorable (higher interest rates and perhaps a total failure of the issue). Therefore, it is estimated that the decision to take loans in advance to finance the fiscal deficit to the end of 2011 and the first half of 2012 is correct, from the point of view of an optimization of the cost of financing.