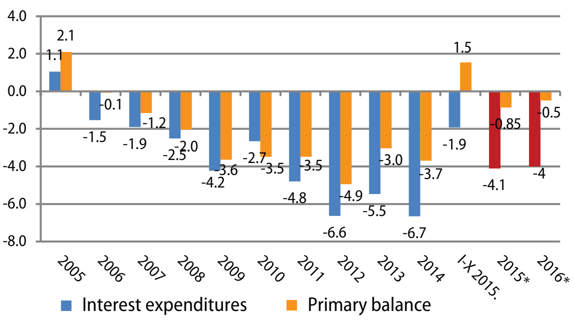
6. Fiscal Flows and Policy

Positive fiscal trends continued in the period July-October, so fiscal results went beyond the expectations again. Accordingly, in the first ten months of 2015 consolidated fiscal deficit (RSD 63.1 billion, or 1.9% of GDP) was smaller than targeted by almost RSD 100 billion because tax revenues exceeded the projected level (primarily VAT, excise tax and contributions), non-tax revenues were collected more aggressively, and some expenditures were postponed or restrained (severance pay and capital expenditures). Although capital expenditures were scaled up in Q3, they will be somewhat lower than budget target for 2015, and much below the CEE average. Continuation of the current trends would result in fiscal deficit at 2.5-3% of GDP at the end of 2015, and the announced settlement of the previously assumed liabilities (towards Gazprom, military pensioners, agricultural producers etc.) would raise this estimate to 3.5-4% of GDP. Fiscal deficit at 4% of GDP at the end of 2015 would mean that it shrank by 2.7% of GDP compared with the last year's level (and would be by 1.9% of GDP below the budget target), and that the structural deficit narrowed by 1.7% of GDP, which would be a notable improvement. However, additional reduction in fiscal deficit down to 2.5% of GDP in the following two years, and to 1% of GDP in the medium term, is necessary to establish sustainable public finance. According to Fiscal Strategy, fiscal deficit for 2016 is expected to remain at the level reached in 2015, and further reduction down to 2.6% of GDP shall be made in 2017. However, this plan is inadequate because the arrangement with the IMF expires in 2017, and 2017 is the election year. Instead, it should be continued with considerable reductions in current spending and a moderate increase in capital expenditures in 2016 and 2017, along with further reduction in fiscal deficit that would be evenly distribute throughout these two years. Public debt (including the debt of local self-governments) totaled 76% of GDP at the end of October, and is expected to reach about 78% of GDP at the end of 2015.

Fiscal tendencies and macroeconomic implications

Fiscal deficit totals RSD 63.1 billion (about 1.9% of GDP) in the first ten months of 2015

Graph T6-1. Serbia: Consolidated fiscal balance and primary balance (% of GDP)[2]



Source: *QM* calculations[3]

In the period July-October 2015 consolidated fiscal deficit totaled RSD 27.7 billion, approximately 2% of the four-month GDP. In the same period, Serbia was running primary surplus of RSD 12.8 billion (1% of the four-month GDP).[1] In the first ten months of 2015 consolidated fiscal deficit totaled RSD 63.1 billion (about 1.9% of GDP), and the budget balance before interest payments showed surplus (primary fiscal surplus) of RSD 50.7 billion (about 1.5% of the ten -month GDP).

In the period July-October fiscal deficit remains below the budget target

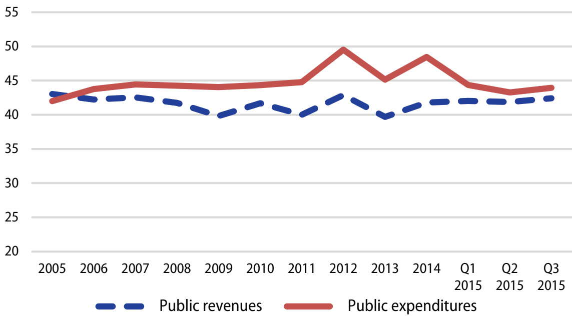
In the period July-October 2015 fiscal deficit accounted for 12% of the annual target, while fiscal deficit in the same period of the preceding years accounted for 24% of the annual deficit. This indicates that fiscal results kept outperforming the projections, as a consequence of growing revenues (primarily revenues from VAT), and a continuous decrease in current spending caused by the measures implemented at the end of 2014, and postponement of some expenditures.

1 Analyses of fiscal trends are based on the Ministry of Finance data on public revenues, public expenditures and public debt, and on other available data on macroeconomic trends.
2 Primary fiscal balance (balance without interests) is the difference between the total public revenues and the overall public expenditures subtracted by expenditures on interest payments.
3 The data for 2015 and 2016 is based on the projections made by the Ministry of Finance and the IMF.

Fiscal deficit in the first ten months of 2015 is smaller than targeted by almost RSD 100 billion …

Due to improved tax collection (VAT, excise tax and contributions), based on reduction in the shadow economy…

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



Source: *QM* calculations based on the MF data

Accordingly, consolidated fiscal deficit in the first ten months of 2015 is smaller than the budget target by almost RSD 100 billion, due to a much improved revenue collection and a slowdown in expenditures.

In Q3, for the first time, real tax revenues grew faster than the overall public revenues, mainly due to a dynamic real y-o-y rise in excise revenues and revenues from VAT, probably driven by increased efforts against the shadow economy, and the excise on electricity. On the other hand, revenues from corporate income tax suffered the largest drop, probably caused by declining profitability of companies. Q3 saw a strong real y-o-y increase in non-tax revenues, though it was somewhat smaller than in the preceding quarters. In the period January-October 2015 real tax revenues stagnated compared with the same period last year, as a net result of a real rise in revenues from VAT (by 1.8%) and excise revenues (by 5%) and a drop in revenues from social security contributions (by 2.5%). Increase in revenues from VAT, and excise revenues (compared with the last year's level) and in contributions (compared with the targeted level) was to a large extent driven by reduction in the shadow economy, and excise on electricity imposed as of August 2015 was another contributory factor. Revenues from VAT and excise revenues grew somewhat faster in Q3 2015 than in the preceding quarter, which is good because these revenues showed a slower rise in Q2 than in the preceding several quarters. On the basis of the intraannual dynamics of revenues in 2015 and in the preceding years, tax revenues in 2015 are expected to exceed the budget target by RSD 40 billion (1% of GDP). Economic growth outperformed the projections, which had positive impact on tax revenues. However, these effects were offset by lower-than-projected inflation rate and slower-than-expected exchange rate depreciation.

…high-pressure collection of dividend pushes up non-tax revenues…

High-pressure collection of dividend and one-off revenues (from sale of licenses etc.) will push non-tax revenues above the annual target (by around RSD 20 billion, or 0.5% of GDP). However, this is a temporary improvement because it is not possible to continuously use a large share of the profit of state-owned and public enterprises in this manner without impairing the capital base of their business activity, and consequently the quality of the services they provide.

Further reduction in public expenditures, as planned

Real y-o-y decrease in public expenditures continued in the period July-October (by 1.3%), though at somewhat slower pace than in the preceding quarters. Reduction in expenditures on wages and pensions (10.6% and 6% respectively), in accordance with the plan, and a considerable real drop in expenditures on subsidies (by 10.6%) contributed the most to this decrease. There was a considerable real rise in capital expenditures compared with the same period last year (by 32.1%). Finally, the reduction in overall expenditures had good dynamics and structure.

Dynamic rise in capital expenditures in Q3, but they are still low

Thanks to the rise in capital expenditures which started at the beginning of the second quarter and accelerated considerably in Q3, total capital expenditures in the first 10 months of 2015 were by 6.5% higher than in the same period last year. This is especially important from the aspect of economic growth because these expenditures have considerable impact on economic activity. However, capital expenditures accounted for only 2.3% of GDP in the first 10 months of 2015, and are expected to total around 2.5% of GDP at the end of the year. This is below the budget target and insufficient, considering the state of infrastructure in Serbia and the average level of capital expenditures in CEE (about 4.5% of GDP), and the fact that capital expenditures have more favorable impact on economic growth than current spending.

Some expenditures remain postponed (severance pay)

At the same time, in the first ten months of 2015 only a small share of the projected amount was spent on severance pay, because privatization and restructuring of public and state-owned enterprises and the process of public sector downsizing were postponed. Consequently, expenditures in 2015 are RSD 15 billion smaller than projected. However, this will push up expenditures in

2016. Postponement of restructuring and privatization and severance pay is not economically justifiable because it could cause additional costs in the following period (on subsidies to these enterprises etc.). Therefore, the status of the state-owned and socially-owned enterprises should be resolved rapidly (privatization), business and financial restructuring of public enterprises should be done, and the plans for public sector rightsizing should be implemented. In the first ten months of 2015 real expenditures were by 2.8% smaller than in 2014, mainly because expenditures on wages and pensions were reduced in accordance with the plan. Expenditures in the first ten months of 2015 fell more than expected because expenditures on severance pay were postponed and capital expenditures were below the targeted level.

FY 2015 deficit is estimated at 3.5-4% of GDP, which is a considerable improvement…

With the current dynamics of public revenues and public expenditures, consolidated fiscal deficit would narrow to 3% of GDP by the end of 2015. However, the announced settlement of previously assumed liabilities (old debt to Gazprom, debt to military pensioners, unpaid subsidies to agricultural producers etc.) by the end of 2015 raises this estimate to 4% of GDP. It is economically justified and correct from the aspect of accounting to show previously assumed liabilities that are to be settled (paid) in 2015 as expenditures and deficit for 2015, and the assumed liabilities that are to be settled next year should be shown as a part of expenditures and deficit for 2016.

…However, further reduction in fiscal deficit is necessary to establish sustainable public finance

Fiscal adjustment of about 2.7% of GDP achieved in 2015 compared with 2014 is important. However, to establish sustainable public finance, it is necessary to reduce fiscal deficit down to 2.5% of GDP in the following two years, in order to stabilize public debt-to-GDP ratio, and then to further reduce it to 1% of GDP, which is considered to be a long-term sustainable level (see the analysis of the 2016 Budget and the announced fiscal policy in *Highlight 1*). According to Fiscal Strategy, fiscal deficit for 2016 shall remain almost unchanged compared with 2015, and further reduction in fiscal deficit of around 1.5% of GDP shall be made in 2017. However, this plan is inadequate because the arrangement with the IMF expires in 2017, and 2017 is the election year. Instead, further evenly distributed reduction in fiscal deficit of 1% of GDP annually both in 2016 and 2017, and moderate annual increase in capital expenditures of 0.3-0.5% of GDP should be continued.

Trends in public debt

Serbia's public debt totaled EUR 24.3 billion at the end of October (74.8% GDP)...

At the end of October 2015 Serbia's public debt totaled EUR 24.3 billion (74.8% of GDP), and including the debt of local self-governments the percentage goes up to 76% of GDP.

...and including the debt of local self-governments – 76% of GDP

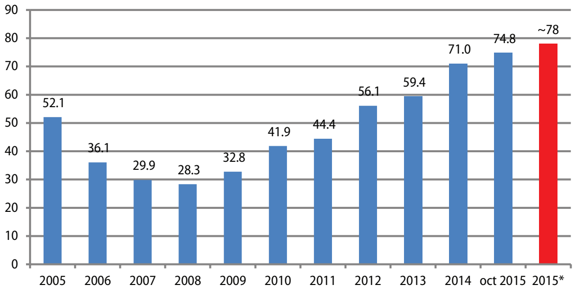
From the end of June to the end of October 2015 public debt grew by EUR 260 million, as a result of the growing direct debt and a slight reduction in indirect debt. The largest share of this increase was used to finance fiscal deficit which totaled EUR 230 million in the period July-October. At the same time, public debt grew by 0.3% of GDP, which is smaller than the absolute amount of growth, because GDP grew slightly. Public debt grew by almost EUR 1.6 billion from the beginning of the year, and a large share of this increase (almost one billion EUR) came from a strong depreciation of dinar against US dollar (by more than 20%), while the remaining amount came from government borrowing needed to finance fiscal deficit. Changes in dinar to dollar exchange rate had negative impact at the beginning of the year, and from the middle of 2015 exchange rate was a neutral factor, because real dinar to euro and dinar to dollar exchange rate remained almost unchanged in the preceding few months

Indirect debt is shrinking slightly

In the period July-October indirect debt shrank slightly (by EUR 50 million), meaning that the downward trend from the preceding period continued, so the overall reduction in indirect debt in the first ten months of 2015 totaled around EUR 110 million. Although this is a good result, we believe that the key drivers of indirect debt have not been eliminated (this was discussed in detail in QM41), and that it might rebound in the following period if privatization and business and financial restructuring of state-owned and socially-owned enterprises are not finished within the established deadlines. There have been many announcements of privatization of some of these enterprises (from the petrochemical complex), but unfortunately none of them was realized.

Public debt will amount to almost 78% of GDP at the end of 2015

Graph T 6-4. Trends in Serbia's public debt (% of GDP)



Source: *QM* calculations

Assuming that real dinar exchange rate remains unchanged, and that borrowing in advance of need remains within the expected level, and that no new government guarantees are issued, and that the government borrowing remains at the level needed to finance the deficit, public debt will reach 77% of GDP, and including the debt of local self-governments it will total 78% of GDP. This is unsustainable in the long term and suggests that the extraordinary fiscal results achieved in 2015 should be used to further reduce fiscal deficit in the following period, instead of increasing current spending.

Appendices

Annex 1. Serbia: Consolidated General Government Fiscal Operations1), 2008-2015 (nominal amounts, bn RSD)

	2008	2009	2010	2011	2012	2013	2014					2015			
							Q1	Q2	Q3	Q4	Q1-Q4	Q1	Q2	Q3	jan-oct
I PUBLIC REVENUES	**1,193.5**	**1,200.8**	**1,278.4**	**1,362.6**	**1,472.1**	**1,538.1**	**352.9**	**403.3**	**407.6**	**457.0**	**1,620.8**	**380.5**	**424.7**	**432.5**	**1,377.1**
1. Current revenues	1,143.1	1,139.2	1,215.7	1,297.9	1,393.8	1,461.3	334.9	383.7	385.4	436.8	1,540.8	379.5	422.7	430.6	1372.1
Tax revenue	1,000.4	1,000.3	1,056.5	1,131.0	1,225.9	1,296.4	301.3	348.7	344.8	375.1	1,369.9	324.9	368.7	373.3	1188.0
Personal income taxes	136.5	133.5	139.1	150.8	35.3	156.1	32.2	35.1	36.9	42.2	146.5	32.5	35.6	37.6	118.1
Corporate income taxes	39.0	31.2	32.6	37.8	54.8	60.7	15.5	29.8	14.2	13.2	72.7	13.0	25.9	11.5	53.8
VAT and retail sales tax	301.7	296.9	319.4	342.4	367.5	380.6	93.6	97.0	101.7	117.3	409.6	96.2	100.1	108.2	345.8
Excises	110.1	134.8	152.4	170.9	181.1	204.8	42.9	55.2	58.4	56.0	212.5	46.3	57.2	63.8	182.5
Custom duties	25.8	48.0	44.3	38.8	35.8	32.5	7.3	7.5	7.8	8.6	31.2	7.9	7.9	8.3	27.2
Social contributions	312.7	318.8	323.0	346.6	378.9	418.3	99.3	109.8	110.7	120.6	440.3	115.6	125.9	126.7	410.3
Other taxes	35.6	37.1	46.0	43.5	42.6	43.5	10.7	14.3	15.1	17.2	57.3	13.4	16.0	17.2	50.3
Non-tax revenue	0.0	138.8	159.2	36.9	37.9	34.9	33.7	35.0	40.5	61.7	170.9	54.6	54.1	57.3	184.1
2. Capital revenues	1.4	0.9	0.3	2.0	8.7	3.5	0.4	0.6	0.4	0.6	2.0	1.0	1.9	1.9	5.1
	0.0														
II TOTAL EXPENDITURE	**-1,265.5**	**-1,328**	**-1,419.5**	**-1,526.1**	**-1,717.3**	**-1,750.2**	**-421.0**	**-448.3**	**-447.4**	**-562.2**	**-1,878.9**	**-401.7**	**-438.9**	**-448.3**	**-1,440.3**
1. Current expenditures	-1,089.6	-1,155	-1,224.8	-1,324.8	-1,479.9	-1,549.8	-381.7	-393.6	-398.0	-454.7	-1,628.0	-383.8	-406.0	-410.4	-1338.3
Wages and salaries	-293.2	-302.0	-308.1	-342.5	-374.7	-392.7	-95.7	-97.9	-96.4	-98.6	-388.6	-98.8	-104.3	-103.1	-339.2
Expenditure on goods and services	-181.4	-187.4	-202.5	-23.3	-235.7	-236.9	-50.9	-58.3	-60.2	-87.4	-256.8	-50.9	-58.8	-65.0	-197.4
Interest payment	-17.2	-187.4	-34.2	-44.8	-68.2	-94.5	-35.5	-28.6	-26.8	-24.2	-115.2	-40.6	-32.7	-32.4	-113.8
Subsidies	-77.8	-22.4	-77.9	-80.5	-111.5	-101.2	-19.4	-23.7	-27.9	-46.1	-117.0	-18.7	-23.8	-25.3	-80.0
Social transfers	-496.8	-63.1	-579.2	-609.0	-652.5	-687.6	-170.7	-172.4	-172.8	-181.0	-696.8	-166.7	-173.8	-174.8	-574.1
o/w: pensions5)	*-331.0*	-556.4	*-394.0*	*-422.8*	-473.7	-498.0	-125.0	-126.9	-128.0	-128.1	-508.1	-121.0	-122.8	-122.1	-407.0
Other current expenditures	-23.5	-387.3	-22.9	-31.7	-37.4	-36.9	-9.6	-12.6	-14.0	-17.5	-53.7	-8.1	-12.5	-9.9	-33.8
2. Capital expenditures	-106.0	-24.0	-105.1	-111.1	-126.3	-84.0	-13.9	-25.3	-23.7	-33.7	-96.7	-10.5	-23.8	-29.7	-75.5
3. Called guarantees	-1.6	-2.2	-2.7	-3.3	-3.7	-7.9	-3.4	-5.9	-8.2	-12.1	-29.7	-6.9	-8.2	-7.5	-24.3
4. Buget lendng	-19.3	-24.0	-30.0	-25.0	-38.2	-35.6	-5.2	-5.8	-0.3	-44.1	-55.4	-0.5	-0.9	-0.7	-2.2
III CONSOLIDATED BALANCE	**-72.0**	**-127.1**	**-141.0**	**-163.5**	**-245.2**	**-212.1**	**-68.1**	**-45.0**	**-39.8**	**-105.2**	**-258.1**	**-21.2**	**-14.2**	**-15.8**	**-63.1**

Source: *QM* calculations based on the MF data

Annex 2. Serbia: Consolidated General Government Fiscal Operations, 2008-2015 (real growth rates, %)

	2008	2009	2010	2011	2012	2013	2014					2015			
							Q1	Q2	Q3	Q4	Q1-Q4	Q1	Q2	Q3	jan-oct
I PUBLIC REVENUES	**3.3**	**-8.9**	**-1.5**	**-4.6**	**0.6**	**-2.2**	**-0.8**	**4.3**	**3.5**	**5.4**	**3.2**	**6.9**	**3.5**	**4.5**	**4.1**
1. Current revenues	3.5	-9.1	-1.5	-4.4	0.1	-2.6	-0.3	4.3	2.8	5.7	3.3	6.8	3.3	5.3	4.3
Tax revenue	3.7	-8.8	-2.5	-4.1	1.0	-1.7	-1.0	6.4	3.8	4.3	3.5	1.3	-1.1	1.6	0.0
Personal income taxes	6.3	-10.8	-3.9	-2.9	2.1	-12.2	-17.8	-13.5	0.8	-1.7	-8.1	0.1	-0.3	0.2	-0.7
Corporate income taxes	18.5	-27.0	-3.6	3.9	35.1	2.9	-18.0	165.3	-9.5	-18.1	17.4	-17.1	-14.5	-20.1	-17.5
VAT and retail sales tax	2.5	-10.2	-0.7	-4.0	0.0	-3.8	4.3	-3.6	5.4	15.1	5.4	1.9	1.5	4.7	1.8
Excises	0.7	11.6	4.2	0.6	-1.2	5.1	-1.7	0.8	9.5	-2.4	1.6	7.1	1.9	7.6	5.0
Custom duties	1.8	-32.4	-14.9	-21.5	-14.0	-15.6	-4.4	-7.0	-6.9	-7.3	-6.5	9.1	4.0	4.9	5.5
Social contributions	4.3	-7.0	-6.5	-3.9	1.9	2.6	3.6	29.1	28.1	0.5	3.1	-1.2	-3.0	-2.4	-2.5
Other taxes	-2.3	-4.9	14.5	-15.2	-8.8	-5.2	12.1	8.2	0.8	44.1	29.2	24.1	9.9	12.4	13.3
Non-tax revenue	2.6	-11.3	5.8	-6.1	-6.2	-8.7	6.0	-13.1	-5.1	15.1	1.5	58.8	49.0	37.9	44.3
2. Capital revenues	-76.8	-41.4	-66.8	468.2	304.5	-63.0	-79.6	17.6	-27.7	6.0	-33.3	25.3	51.3	-60.0	-31.6
II TOTAL EXPENDITURE	**5.0**	**-4.8**	**-1.7**	**3.3**	**4.3**	**-0.3**	**4.4**	**3.7**	**-3.0**	**14.8**	**5.2**	**-5.4**	**-3.8**	**-1.3**	**-2.8**
1. Current expenditures	6.9	-3.3	-2.2	3.1	4.1	-2.7	6.0	0.4	-1.2	6.5	2.9	-4.5	-3.0	-2.6	-3.0
Wages and salaries	10.9	-6.0	-5.9	0.4	2.0	-2.6	-0.6	-2.0	-3.0	-6.5	-3.1	-12.9	-11.3	-10.6	-11.8
Expenditure on goods and services		-5.7	-0.3	4.3	1.5	-6.6	-0.1	3.4	-1.6	19.1	6.2	-1.0	-0.8	6.3	2.8
Interest payment	-2.8	-5.7	-0.3	17.4	41.9	28.8	82.9	2.2	-3.4	13.6	19.3	13.2	12.2	19.2	12.8
Subsidies	-13.3	19.0	40.6	7.4	29.1	-15.6	-0.8	6.0	-3.8	41.9	13.2	-4.1	-1.4	-10.6	1.4
Social transfers	10.1	-26.0	13.9	5.8	-0.1	-2.1	2.4	-2.2	-1.8	-1.2	-0.7	-3.2	-0.9	-0.4	-1.3
o/w: pensions5)	*9.5*	2.2	-3.9	3.9	*4.4*	*-2.3*	*1.5*	*0.0*	*0.2*	*-2.0*	*-0.1*	*-4.1*	*-4.9*	*-6.0*	*-5.1*
Other current expenditures	14.9	6.7	-6.1	23.9	9.9	-8.4	31.1	36.2	43.1	55.0	42.6	-15.8	-2.4	-30.5	-19.3
2. Capital expenditures	-4.3	-6.7	-11.8	5.3	6.0	-38.2	1.4	41.5	-12.8	25.2	12.7	-25.4	-7.4	23.2	6.5
3. Called guarantees	283.5	-2.2	-2.7	-3.3	-3.7	248.7	40.7	439.8	417.0	310.5	267.8	98.8	34.8	-9.7	23.3
4. Buget lendng	13.3	-24.0	-30.0	-25.0	-38.2	44.2	-36.1	45.5	-97.4	237.4	52.2	-90.9	-85.2	126.3	-81.1

Source: *QM* calculations based on the MF data