HIGHLIGHT

Highlight 1. Analysis and evaluation of Serbian fiscal policy in 2016

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Considerable fiscal adjustment (reduction in fiscal deficit) of about 2.7% of GDP was made in 2015 compared with 2014. This was achieved through implementation of fiscal consolidation measures adopted at the end of 2014, increased efforts against the shadow economy, and the influence of a number of one-off and temporary factors, some of which caused a further reduction in fiscal deficit (high-pressure collection of dividend paid by public and state-owned enterprises, revenues from the sale of licenses, postponed subsidy payments to agricultural producers, and delay in rationalization of the public sector and severance payments). On the other hand, some factors operated to widen the deficit (previously assumed liabilities to military pensioners, Gazprom etc.). Additionally, economic growth in Serbia in 2015, although stronger than targeted, was still below the natural growth rate (estimated at 3-4% annually), which was another factor that pushed down public revenues and hindered reduction in fiscal deficit. In general, all these one-off and temporary factors increased the final amount of fiscal deficit by 1% of GDP, so it stands at 4.1% of GDP.

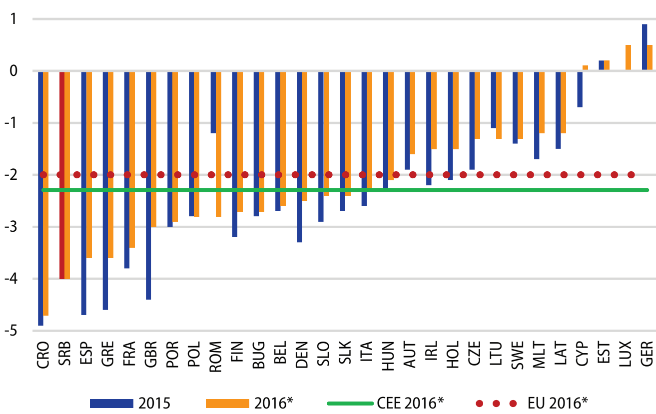
Table 1 Public revenues, public expenditures and fiscal deficit in Serbia, % of GDP

	2015	*2016*	*Change 2016-2015.*
Public revenues	42.2	41.3	-0.9
Public expenditures	46.3	45.3	-1
Fiscal deficit	-4.1	-4	0.1
Structural fiscal deficit	-3.1	-3.4	0.3

Source: *QM* based on the MF data

Fiscal adjustment made in 2015 is considerable and represents a step forward to establishing sustainable public finance. However, for fiscal consolidation to succeed, continued implementation of measures that would provide further reduction in fiscal deficit is necessary. The program of fiscal consolidation is aimed at reducing fiscal deficit to the level that would stabilize public debt-to-GDP ratio, meaning that fiscal deficit needs to be reduced down to 2.5% of GDP in the next two years, and then to 1% of GDP in the medium term. According to the fiscal strategy, fiscal deficit for 2016 shall remain almost unchanged compared with 2015 (4% of GDP), and further reduction of around 1.4% of GDP (down to 2.6% of GDP) shall be made in 2017. Fiscal deficit target set for 2017 is an attainable goal, but the dynamics of further adjustment are inadequate. Credible program of fiscal consolidation is the one that provides a continuous reduction in fiscal deficit down to a sustainable level. Accordingly, the plan to keep the total fiscal deficit in 2016 at the level reached in 2015 (along with a slight widening of structural deficit) is inadequate, regardless of the fact that it is a result of postponed settlement of some of the previously assumed liabilities. This indicates that the pace of fiscal consolidation slowed notably at the end of 2015, after the initial success was achieved in the first year of implementation of the program. Targeted fiscal deficit of 4% of GDP for 2016 will be the second largest deficit in Europe (larger deficit is projected only in Croatia), and will exceed the CEE average (by 2.3% of GDP).

Graph 2 Serbia and EU: fiscal deficit projection for 2015 and 2016 (% of GDP)



Source: *QM* and European Commission

The plan to postpone further reduction in fiscal deficit until 2017 lacks credibility, because 2017 is the election year and the arrangement with the IMF expires in 2017. Accordingly, although purely symbolic, possible increase in wages and pensions is not economically justifiable and will cause a permanent rise in expenditures of about 0.5% of GDP, and elections could additionally increase these expenditures. From the aspect of macroeconomic stability, sustainability of public finance and economic growth, these better-than-expected fiscal results achieved in the first year of fiscal consolidation should be used to reduce fiscal deficit down to 2.5% of GDP by the end of implementation of the program (and then down to 1% of GDP in the following few years).

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Highlights

Further fiscal adjustment (through reduction in current spending) should be evenly distributed in 2016 and 2017 (by 1% of GDP annually), and should be accompanied by an increase in capital expenditures of 0.3-0.5% of GDP each year.

According to revenue projections for 2016, public revenues will fall by 0.9% of GDP mainly because non-tax revenues are expected to go down (by 0.8% of GDP). This is a reasonable forecast because in 2015 there was a high-pressure collection of dividend paid by state-owned and public enterprises, so further continuation of such practice would impair the capital base of their business activity (due to inability to reinvest).

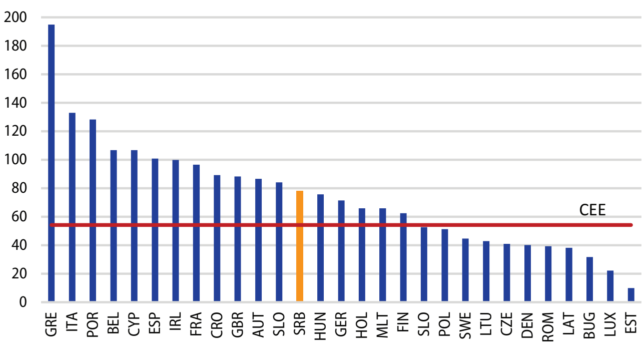
According to expenditure projections for 2016, reduction in total public spending is targeted at 1% of GDP, which is economically justifiable because in 2015 public expenditures in Serbia are by 4% of GDP higher than in comparable CEE countries. The largest cut shall be made in expenditures on subsidies (0.7% of GDP), social expenditures (0.6% of GDP) and expenditures on employees (0.3% of GDP). On the other hand, capital expenditures are expected to go up moderately (by 0.3% of GDP), and expenditures on goods and services, expenditures on interest payments and expenditures on activated guarantees are expected to grow slightly (by 0.1% of GDP each). This new structure of expenditures, taken with a pinch of salt, is considered favorable.

The projected reduction in expenditures on subsidies in 2016, from 3.4% of GDP to 2.7% of GDP, is economically justifiable, especially because they are above the EU average of 1-1.5% of GDP, meaning that further reduction in these expenditures needs to be made in the following years. The largest cut shall be made in agricultural subsidies (abolition of subsidies on farmland with the area over 20 hectares, and for lessees of state land). However, there are some risks that these targets might not be reached because in 2015 the budgeted level of subsidies was not sufficient to pay the envisaged amounts (fragmentation of farmland increased the number of subsidy recipients). Besides, to achieve these savings, social subsidies (per hectare) will have to be halved, and similar earlier attempts to do so show that this will be a tough socio-political task. Total expenditures on agricultural subsidies in Serbia are not much higher than in EU, and it should be mentioned that agricultural producers in EU receive additional money from European funds. Since domestic agricultural producers will not have access to EU funds until Serbia joins EU, larger cuts in agricultural subsidies would impair the competitiveness of domestic agriculture in liberalized agriculture market. Therefore, it would be economically justifiable to keep agricultural subsidies at the previous level but to change the system of distribution so that capital subsidies (for equipment etc.) make a larger share of total subsidies. Additionally, the system of distribution of social subsidies should be modified so that they are granted per unit of production instead of unit of resources used in production. The necessary reduction in subsidies should be made through reduction in non-productive subsidies to public and state-owned enterprises and in subsidies on investments and employment. Additionally, for the sake of transparency, it is very important that all individual subsidy programs (on investments and employment etc.) are stated in the budget.

Projected reduction in expenditures on employees in 2016 is one of the key measures for reducing structural deficit (by 0.3% of GDP), but there is a risk that these savings might not be achieved. The established fiscal framework implies reduction in public sector employees by 29000 in 2016. However, since the reduction in public sector employees in 2015 was way off the targeted 25000, there is a risk that similar could happen in 2016, and that consequently the expected savings might not be achieved.

Further rise in expenditures on interest payments, though slower than in the preceding years, is not welcome. Possible major change in the dinar exchange rate (against euro and dollar) could cause even sharper rise in these expenditures.

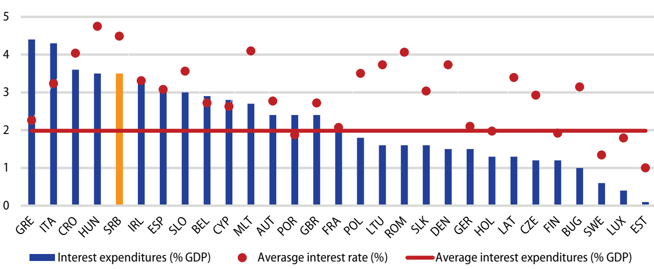
Graph 3 Serbia and EU: Public debt in 2015 (% of GDP)



Source: *QM* calculation based on the MF data

According to the level of public debt-to-GDP ratio Serbia is ranked 13th out of 29 European countries, meaning that it falls into the group of moderately indebted European countries (though it is one of the most indebted countries in CEE), while measured by the relative amount of expenditures on interest payments (as a % of GDP) it is ranked 5th. Expenditures on interest payments account for 3.5% of GDP, far above the CEE average and the EU average (2% of GDP and 2.3% of GDP respectively). Consequently, average interest rate on public debt (the quotient of interest payments and public debt) of 4.6% is the second largest in Europe – only Hungary pays higher average interest rate on public debt (4.7%), while average interest rate on public debt in CEE stands at 3.5%. This is the result of the following factors: *i)* extremely large deficit and years of steep rise in public debt, *ii)* decreasing share of inherited cheap loans, repayment of old foreign currency savings etc., and growing share of new cheaper loans, *iii)* Serbia does not have access to more favorable terms of financing fiscal deficit and public debt that were available to some EU members who financed their deficit in the preceding years on preferential terms. Massive spending on interest payments does not leave much room for financing other productive programs (such as public investments, investments in education etc.). Reduction in expenditures on interest payments down to the CEE average would open up the opportunity to increase public investment and other productive expenditures by around EUR 500 million annually. However, to achieve this, fiscal deficit needs to be reduced considerably in the next two years. Furthermore, a more active public debt management is necessary, and the government should explore the opportunities for refinancing expensive loans with cheaper ones, since the interest rates in financial market are relatively low because fiscal results achieved in 2015 are good and the Fed and ECB are pursuing expansionary monetary policy. Although this cannot be applied to a considerable share of debt due to previously arranged terms of financing, a certain share of debt can be replaced with new cheaper loans, which would slightly reduce expenditures on interest payments. Accordingly, institutional limitations (Law on Public Procurements) that are used as an excuse for a passive approach to public debt management should be adapted to allow the government to take an active approach to this issue.

Graph 4 Serbia and EU: Expenditures on interest payments (% of GDP) and average interest rate (%) in 2015



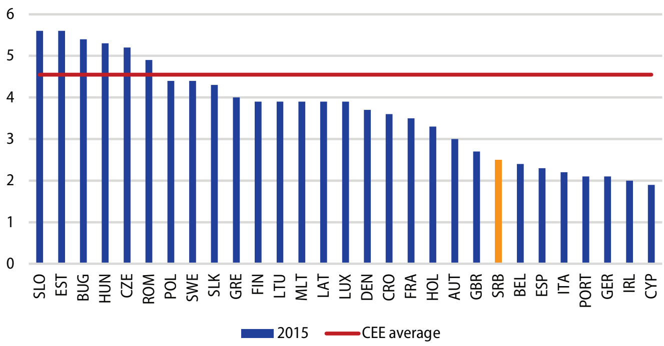
Source: *QM* calculation based on the MF data

Capital expenditures are projected to grow by 0.3% in 2016 compared with 2015, which is good but insufficient to notably improve the quality of infrastructure and accelerate economic growth.[2] According to the Fiscal strategy, the government plans to keep capital expenditures at 3% of GDP in the following three years, explaining that a notable increase in these expenditures will be possible only when economic growth accelerates. This is, however, wrong, because one of the key reasons for low growth rate of Serbian economy is low level of total investment, as a consequence of small public investment (that is the lowest in CEE and by 2% of GDP below the CEE average). On the other hand, the difference between private investment in Serbia and the CEE average is much smaller (around 2% of GDP). Therefore, it would be justifiable to notably increase public investment in the next three years (by 0.3-0.5% of GDP annually), because it would have a double positive effect on economic growth – it would increase demand in the period of their realization, and in the long run it would affect supply, through improved quality of infrastructure.

Capital expenditures (public investment) in EU countries account for 2.9% of GDP on average, and the annual average for 2015 in less developed EU members, from Central and Eastern Europe (CEE), is much higher – 4.5% of GDP. Similarly, in the previous ten years public investment in Serbia was, on average, by 1.5% of GDP lower than in CEE each year, i.e. 15% of GDP (EUR 4.5 billion) in the whole period, which implies a considerable opportunity cost in terms of missed economic growth. Since the infrastructure in Serbia is in poorer condition than in most of these countries, and public investment gives a much stronger stimulus to economic growth than current spending, annual increase in public investment of 0.3-0.5% of GDP is necessary, until it reaches the CEE average. This can be achieved through increased spending on investments and more efficient realization of projects that are financed from the central government budget, and by giving local self-governments systemic incentives to increase the share of public investment in total expenditures. Increase in the share of public investment in total public expenditures of local self-governments from 13% to 20% would imply rise in total public investment of around 0.4% of GDP.

2 It is stated in public that a part of expenditures on subsidies to public enterprises (of about 0.5% of GDP) falls into the category of capital subsidies (funds used by public enterprises to finance investment). Accordingly, these subsidies should be shown separately, as a distinct category. The difference between public investment in Serbia and in other CEE countries would thus be smaller, though they would remain below the CEE level by more than 1% of GDP annually.

Graph 5 Serbia and EU: Capital expenditures in 2015 (% of GDP)



Source: *QM* calculation based on the MF data

Although no major increase in expenditures on direct or indirect subsidies to public, state-owned or socially-owned enterprises that are undergoing privatization (with the exception of capital subsidies to Železnice) is projected in the budget for 2016, there is a certain risk that these expenditures will exceed the targeted level because financial and business restructuring of public enterprises and the process of resolving the status of state-owned and socially owned enterprises (privatization or bankruptcy) are developing much slower than planned. Accordingly, it is necessary to accelerate restructuring of public enterprises (primarily EPS, Srbijagas and Železnice, as the major possible sources of fiscal risks) and heighten the activities directed at resolving the status of state-owned enterprises undergoing privatization (RTB Bor, Azotara, Petrohemija, Železara etc.). RTB Bor is facing EUR 350 million of debt, and it is similar with Petrohemija and other enterprises (though the amount of debt is smaller). If the government takes over these liabilities (as was the case with non-guaranteed debt Srbijagas owed to NIS), fiscal deficit and public debt might widen considerably. Accordingly, the government (i.e. the Ministry of Economy) should take a proactive approach to finding potential buyers for enterprises with market prospects, instead of waiting of for them to appear. Otherwise, if these processes are not finished in the first half of 2016, the government will probably have to subsidize these enterprises or to issue guarantees on loans needed for financing their liquidity, which could impair the whole fiscal consolidation program and the progress that has been achieved in other areas of fiscal policy.

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