6. Fiscal flows and policy

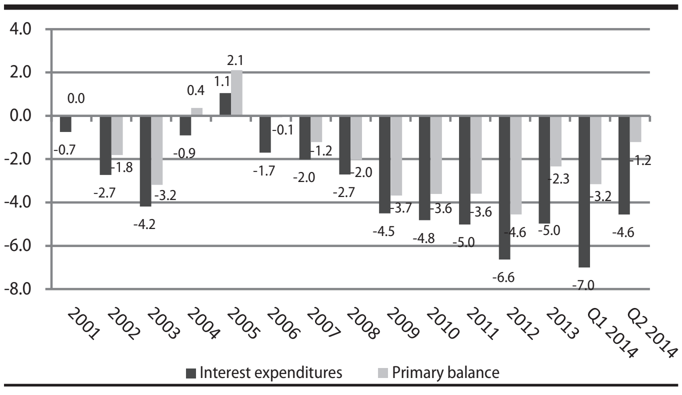
Fiscal deficit, exclusive of below-the-line expenses, stood at RSD 39 billion (about 4.6% of the quarterly GDP) in Q2 2014, and reached RSD 103.7 billion, or about 5% of GDP, in the period January-July. Inclusive of below-the-line expenses, fiscal deficit ran at 6.5-7% of GDP in the period January-July. June and July saw a small surplus in the budget caused by seasonal factors, changes in tax calendar and the change at the post of the Minister of Finance which implies suspension of non-urgent expenses. Therefore, these developments do not reflect a continuing improvement in the health of public finance. Although public expenditures in Q2 remained at the level reached in the preceding quarter, real rise in these expenditures continued relative to the same period last year and they ran at 49.5% of GDP. Without a broad fiscal consolidation, below-the-line fiscal deficit will run at more than 6.5% of GDP in 2014 (and inclusive of below-the-line expenses it will widen to more than 8% of GDP), which is much above the projections, and is primarily driven by decrease in revenues. Public debt totaled EUR 20.9 billion (67.1% of GDP) at the end of July, and, under other circumstances unchanged, it could reach 70-72% of GDP by the end of the year, or even exceed this projection. Extremely large and growing fiscal deficit involves a high risk of public debt crisis. Strong fiscal consolidation, primarily through reduction in current expenditures, that would provide for fiscal deficit shrinking to 3% of GDP by 2017, i.e. EUR 1.5-2 billion reduction in expenditures and rise in revenues, is therefore necessary.

General tendencies and macroeconomic implications.

Official consolidated fiscal deficit in the first seven months of 2014 stands at RSD 103.8 billion (about 5% of GDP)

To July inclusive, consolidated fiscal deficit, excluding below-the-line expenses (such as payments for activated guarantees granted to public companies), ran at RSD 103.7 billion or 5% of GDP, and inclusive of these expenses it ran at 6.5-7% of GDP.[1] Fiscal deficit in the period January-July 2014 accounted for 42.2% of the total projected annual deficit, which is somewhat below the relative amount of deficits recorded in the first seven months of the preceding years. This primarily came from a considerable reduction in fiscal deficit in June and July caused by seasonal factors, changes in tax calendar and the Minister of Finance's resignation (during the change at the post of Minister of Finance fiscal deficit is usually small because the outgoing minister most often approves only the most urgent expenditures, while his successor needs some time to familiarize himself with fiscal flows). The foregoing developments were driven by a slight rise in public revenues and unchanged public expenditures relative to the preceding four months. However, when compared with the preceding year, a moderate real rise in public expenditures continued so they ran at 49.5% of GDP in Q2, which is extremely high relative to other Central and Eastern European countries.

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



Source: *QM* calculation.

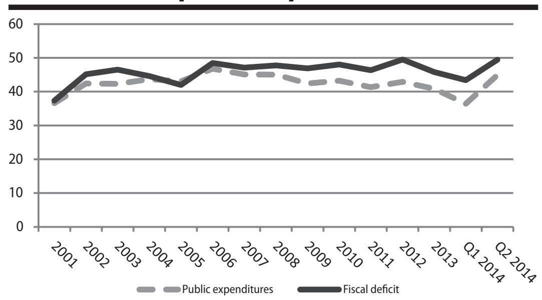
1 Primary fiscal deficit (deficit without interests) is the difference between the total public revenues and the overall public expenditures subtracted by expenditures on interest payments.

1 Below-the-line expenditures, recognized as a part of consolidated public expenditures according to international (GFS) methodology, while domestic methodology does not recognize them as such, include budget expenditures on activated guarantees granted to public companies (e.g. Srbijagas), budget expenditures on financial rehabilitation of banks, and similar. To achieve greater transparency of data on fiscal flows and to obtain internationally comparable data on public expenditures and fiscal deficit in Serbia, Ministry of Finance must start making regular monthly reports on these expenditures, and recognize them as a part of consolidated public expenditures (see Highlight 1).

Primary fiscal deficit runs at 0.5% of GDP in the period April-July 2014 … and inclusive of below-the-line expenditures it reaches 1.5% of GDP

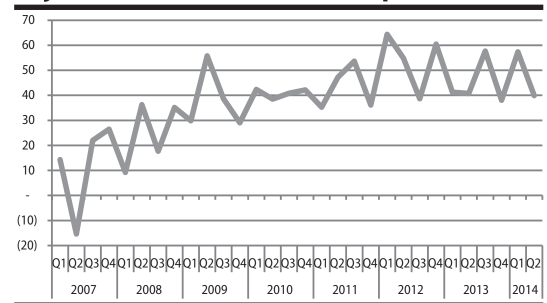
Primary fiscal deficit (fiscal deficit without expenditures on interest payment) ran at 0.5% of GDP in the period April-July 2014. In the first seven months of 2014 official primary fiscal deficit stood at 1.7% of GDP, while primary fiscal deficit inclusive of below-the-line expenditures ran at 3% of GDP, meaning that expenditures on interest payment make more than a half of consolidated fiscal deficit. Expenditures on interest payment are becoming one of the main generators of fiscal deficit. Consequently, fiscal deficit could become self-generating in the future.

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



Source: *QM* calculation

Graph T 6-3. Serbia: Real seasonally adjusted fiscal deficit (in 2013 prices)



Source: *QM* calculation

...due to decrease in revenues caused by unfavorable macroeconomic circumstances

Fiscal trends detected in the first seven months suggest that if other circumstances remained unchanged, in spite of the positive developments in June and July, public revenues in 2014 could fall short of the plan by about RSD 50 billion primarily due to changed macroeconomic circumstances. Public revenues were below the targeted due to several factors: i) downward revision of the nominal GDP carried out by the Statistical Office of the Republic of Serbia (SORS); ii) GDP slowdown (instead of the projected 1% growth rate, GDP will fall by 1%); iii) inflation rate below the expected (the budget was drawn up on the basis of the projected average inflation rate of 5.5%, but it now stands at 2% annually), which has negative impact on revenues from consumption taxes; iv) dinar depreciation below the expected level (which will have negative impact on revenues from VAT and customs duty, but will affect expenditures on interest payments favorably); v) downwards trends in labor market, leading to loss of revenues from personal income tax and social security contributions; vi) negative effect of floods on economic activity and tax revenues in flooded areas. By imposing a tougher spending control, and limiting or delaying certain expenditures, the government will manage to make a limited reduction in the overall expenditures.

Growth of shadow economy is slowing down ... some measures against it taken during the summer ... but there is still a great deal of room for maneuver

Growing shadow economy was an important cause of the decrease in public revenues in 2013 and at the beginning of 2014. Fiscal trends detected in the succeeding months, primarily in terms of domestic VAT and excise duties on certain goods, indicate a slight stabilization in this area, and a slower growth rate or even a slight reduction in shadow economy activities in some segments (trade in petroleum products etc.). Additionally, amendments to the Law on Tax Procedre and Tax Administrationm,introducing tougher penalties for tax evasion or failure to file tax return were adopted in June, and in July Tax Administration embarked on intensive control of illegal retail trade of goods and services, which resulted in closing down of a number of restaurants and retail shops. Measures against shadow economy to be fully effective (EUR 100 million annually in the following three years), the Tax Administration must continue and intensify their control on taxpayers and a number of state institutions must coordinated their actions to close the channels of illegal wholesale of goods (primarily excise goods). Intensified control by the Tax Administration should be given proper media coverage to make taxpayers aware of the increased possibility of being caught and fined.

Without strong fiscal consolidation, fiscal deficit in 2014 (exclusive of below-the-line expenditures) will widen to 6.5% of GDP...

Slight improvement in the state of public finance detected in June and July was driven by seasonal factors (larger turnover during the summer), changes in tax calendar (corporate income tax falls due in June instead of March), and onetime factors, such as change at the post of the Minister of Finance, which usually implies delay of non-urgent expenditures. Taking into account the foregoing effects, and the fact that revenue collection in the period January-July was below the projections, and that certain reductions in expenditures were made, and since fiscal deficit in the second half of a year is larger than in the first six months, consolidated fiscal deficit in 2014 (exclusive of below-the-line expenditures) is estimated at 6.5% of GDP, which is much above the expected level (5.5% of GDP).

...and inclusive of below-the-line expenditures it will exceed 8% of GDP

Fiscal deficit inclusive of below-the-line expenditures, recognized as a part of consolidated expenditures according to internationally comparable methodology, will exceed 8% of GDP in 2014, and will be one of the largest in Europe. Since capital expenditures take less than 3% of GDP, the largest share of fiscal deficit comes from current spending, which is unjust from the aspect of intergenerational equity.

Urgent implementation of fiscal consolidation program aimed at reduction in current expenditures that would provide EUR 1.5-2 billion reduction in fiscal deficit is necessary to prevent bankruptcy

Fiscal deficit above 8% of GDP, mostly structural deficit, is unsustainable even in the mid-term. Urgent implementation of a credible fiscal consolidation program designed to reduce fiscal deficit to 3% of GDP by 2017, which implies EUR 1.5-2 billion reduction in expenditures and rise in revenues, is therefore necessary to prevent public debt crisis. Fiscal consolidation should be based on reduction in current expenditures rather than tax increase, because large fiscal deficit in Serbia does not come from low taxes but from high public spending. Sale of state-owned property would not eliminate the need for fiscal consolidation (although privatization of certain public and state-owned companies is economically justifiable) but only delay it for a while, and subsequently, measures for fiscal consolidation would be even more drastic, and Serbia's asset, economic and political position would weaken.

Box 1. Evaluation of parametric reform of the pension system

After years of announcements, amendments to the Law on Pension and Disability Insurance were adopted in July, introducing substantial parametric reform of the pension system. Among other things, the amendments envisage that the statutory retirement age for women shall be raised gradually from 60 to 65 years, pension payments for early retirement shall be reduced by 4.08% for every year shy of statutory retirement age, minimum early retirement age shall be increased to 60 at a faster pace, and the persons doing administrative jobs will be ineligible for accelerated retirement scheme. Additionally, following the best practices in developed countries (such as Germany), women with children are entitled to register additional months of service. This measure is intended to valorize additional effort women put in giving birth to children and bringing them up, often deployed as an argument against equation of statutory retirement age for men and women.

This reform of pension system is considered appropriate and necessary, and represents a big step forward in reforms made by the new Government (together with the Labor Law). This reform aims at long term sustainability of pension system, because the foregoing changes are expected to provide for reduction in expenditures on pensions of more than 1% of GDP annually, in the long run. Reform parameters are economically justifiable and in accordance with the practices adopted in almost all EU states (in most EU states statutory retirement age for women is 65 years, all EU states impose penalties for early retirement, etc.). Although the reform of pension system is appropriate and justifiable, it will produce quite modest effects in the mid-term (the following 2-3 years), meaning that a single reduction in expenditures on pensions is still necessary.

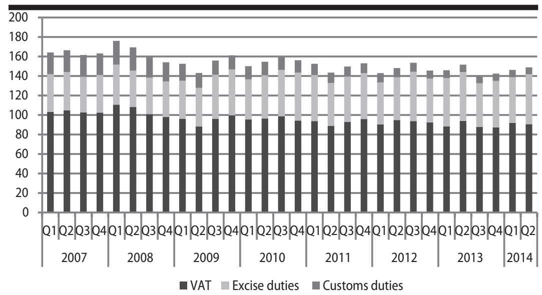
Analysis of the dynamics and structure of public revenues and public expenditures

Public revenues are going up slightly in the period January-July

Public revenues went up slightly in the period April-January 2014 - compared with both the same period last year and the preceding four months real seasonally adjusted public revenues went up by 3.9%. This rise in public revenues primarily came from a steep rise in revenues from corporate income tax (due to changes in tax calendar) and excise revenues and moderate rise in revenues from social security contributions. Other public revenues either remained unchanged or went down.

There is a slight rise in revenues from VAT, but they are still below the last year's level

Graph T 6-4. Serbia: Trends in real consolidated seasonally adjusted revenues from consumption tax (in 2013 prices)



Source: *QM* calculations

Real seasonally adjusted revenues from VAT collected in the period April-July went up slightly (by 0.6%) compared with the preceding four months. However, compared with the same period 2013 these revenues went down (by 3.9%), in spite of VAT rate increase. June and July saw a moderate rise in revenues from VAT driven by slight depreciation of dinar exchange rate, and possibly by modest reduction in shadow economy activities which came from tougher punitive measures and intensified control on fiscal receipt issuing. Tax Administration and other inspection authorities need to intensify their actions against shadow economy and increase efficiency in tax collection to maintain and boost the rise in revenues from VAT.

Excise revenues are going up considerably because illegal trade in petroleum products has been curbed

Real seasonally adjusted excise revenues collected in the period April-July went up (by 9.9%) compared with the preceding four months, and when compared with the same period 2013 these revenues increased considerably (by 6.4%). Excise revenues rose mainly because illegal trade in diesel fuel and other petroleum products (through the process of fuel marking) had been curbed successfully. On the other hand, collection of excise revenues from tobacco products proved inefficient, although this could be a rich source of tax revenue if illegal trade in these products was curbed.

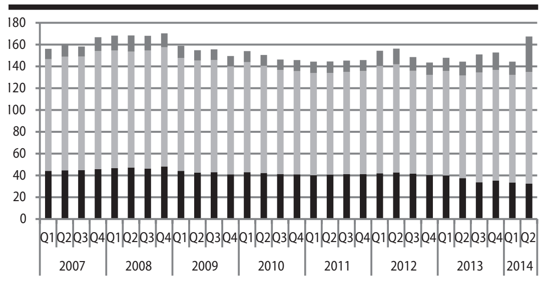
Drop in custom revenues continues

In the period April-July 2014 real custom revenues went down moderately (by 7.7%) compared with the same period last year, and the same decline is posted when compared to April-July 2013. This decrease in custom revenues can be attributed to slowdown in exports, liberalization of foreign trade, and possibly changes in the structure of imported goods regarding its type and country of origin, meaning that goods that are subject to lower custom duties and the goods imported from the signatory countries to free trade agreement with Serbia predominate.

Revenues from personal income tax are going down, and revenues from social security contributions are rising slightly

Revenues from personal income tax (real, seasonally adjusted) went down slightly (by 3.1%) in the period April-July compared with the preceding four-month period, and when compared with the same period last year, these revenues suffered a considerable drop (by 10.9%). This drop in revenues from personal income tax in the period April-July 2014 compared with the same period last year can be attributed to reduction in tax rate for wages as of June 2013. Decrease in revenues from personal income tax in this period compared with the preceding four-month period can be attributed to fall in real wages and increase in informal employment. Additionally, steep real drop in tax revenues from outside of employment income (income from capital, royalties, self--employment etc.) of 11.5% in Q2 relative to the same period last year, pushed down revenues from personal income tax.

Graph T 6-5. Serbia: Trends in real consolidated seasonally adjusted revenues from taxes on factors of production (in 2013 prices)



Source: *QM* calculation

Seasonally adjusted revenues from social security contributions went up moderately (by 2.7%) in the period April-July compared with the preceding four-month period, and when compared with the same period last year, real rise in these revenues was stronger (by 7.1%). This rise in revenues from social security contributions in the period April-July 2014 compared with the same period last year came from increase in the rate of old-age pension and disability pension contributions. Rise in revenues from social security contributions in this period compared with the preceding four-month period could indicate that the state embarked on a more intensive collection of outstanding social security contributions.

Revenues from corporate income tax are going up steeply due to changes in tax calendar

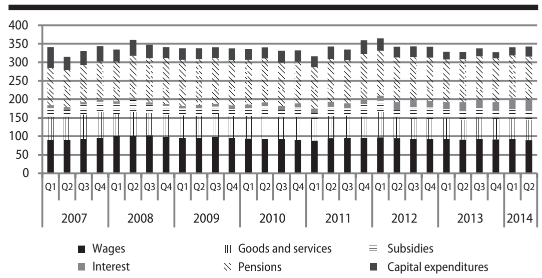
Real seasonally adjusted revenues from corporate income tax collected in the period April-July were much higher than in the preceding four months, or in the same period last year (by 122.1% and 113.9% respectively). Steep rise in revenues from corporate income tax in this period compared with the preceding quarter can be attributed to changes in tax calendar, according to which corporate income tax for 2013 falls due in June 2014, and not in March as was previously the case. Strong real rise in revenues from this tax in the first seven months of 2014 relative to the same period last year (47.3%) came from the increase in corporate income tax rate from 10% to 15%, which influenced only advance tax payments in 2013, but in 2014 it affected the final tax liability, as well. Additionally, rise in revenues from corporate income tax can partly be attributed to greater profitability of companies in 2013 relative to 2012. According to the data released by the Serbian Business Registers Agency, companies in Serbia generated cumulative profit of almost RSD 27 billion in 2013, and suffered cumulative loss of RSD 78.5 billion in 2012.

Other tax revenues are rising considerably, and non-tax revenues are going down, due to the reforms in property taxation

Other tax revenues grew considerably (by 12.4%) in the period April-July 2014 compared with the preceding four months, and when compared with the same period last year this real rise is even steeper (by 23.7%). At the same time, non-tax revenues (real, seasonally adjusted) went down (by 8.5%) in this period relative to the preceding for months, and when compared with the same period 2013, real drop in these revenues was 11.1%. This rise in other tax revenues is the result of changes to property tax calculation method, and the drop in non-tax revenues was caused by abolition of building land use fee, which has been integrated into property tax as of 2014.

Public expenditures remained unchanged in the period April-July

Graph T 6-6. Serbia: Trends in consolidated seasonally adjusted public expenditures (in 2013 prices)



Source: *QM* calculation

Real seasonally adjusted public expenditures remained almost unchanged in the period April-July (0.1% rise) compared with the preceding four-month period, and when compared with the same period last year, real rise in these expenditures was somewhat higher (1.9%). Under falling GDP, this resulted in relative rise in public expenditures (to 49.5% of GDP in Q2).

Expenditures on subsidies are rising slightly due to implementation of new subsidy programs

After a period of a slowdown, real seasonally adjusted expenditures on subsidies increased slightly (by 1.8%) in the period April-July relative to the preceding four months, and when compared with the same period 2013 this rise is stronger (by 12.1%). Rise in expenditures on subsidies entirely came from the increase in subsidies paid from the central government budget (while the level of subsidies paid from the local budgets fell considerably), which was driven by specific dynamics in subsidy payments to agricultural producers, and adoption of new subsidy scheme for RTS (national broadcasting company of Serbia), which is considered fiscally, economically and socially unjustifiable. Announced reintroduction of subsidies for investments and employment, realization of subsidies for liquidity loans and similar will result in further rise in these expenditures in the following period. Subsidies for investments and employment are justifiable if their amount is limited, if they are granted in a limited number of cases (for large investments that result in inflow of a number of small investments) and during a very limited time period, and cannot make up for reform in business environment.

Capital expenditures are going up but they are still low

Real seasonally adjusted capital expenditures went up steeply in the period April-July 2014 (by 31%) compared with the preceding four months, and when compared with the same period last year, they increased by 35.3%. Capital expenditures went up mainly because the government discharged its liabilities for performed infrastructure works. The upwards trend in capital expenditures detected in Q1 2014 continued, so these expenditures accounted for 3% of GDP in Q2, which is higher than in the preceding periods but still below the necessary level (about 5% of GDP), and much below the quarterly fiscal deficit (by 1.6% of GDP). This suggests that the future generations will have to shoulder 1/3 of the current fiscal deficit burden, which is unjust from the aspect of intergenerational equity.

Expenditures on goods and services are going up slightly

There was a slight real rise in expenditures on goods and services in the period April-July 2014 (by 1%) compared with the preceding quarter, and when compared with the same period last year, the rise was somewhat higher (3.8%). This slight rise in these expenditures, primarily at the level of central government and Health Insurance Fund of the Republic of Serbia, is the result of floods, and partly of procurements and payments for procured goods or services that were subject to delay previously.

There was a slight temporary decrease in expenditures on interest payments in the period April-July

After a steep rise in expenditures on interest payments in Q1, driven by payment of due coupons on euro-denominated bonds, these expenditures went down slightly (by 1.8%) in the period April-July 2014. They were somewhat lower (by 2.9%) than in the same period 2013. Decrease in expenditures on interest payments is the result of a high base for comparison. They will probably rebound in the following period due to growing public debt (and consequential increase in principal, but also rise in interest rates caused by higher country risk) and changed structure of public debt (share of cheap debt – e.g. old foreign currency savings) is shrinking in favor of new expensive loans. Government bonds of the Republic of Serbia are traded at quite favorable prices on the secondary market, primarily due to high availability of capital in international market, but also because investors have certain expectations about the announced economic reforms. However, strong real rise in expenditures on interest payments (by 28.3%) in the first seven months of 2014 relative to the same period 2013 indicate a continuing upwards trend in these expenditures driven by growing debt and consequently tougher borrowing conditions.

Slight decrease in expenditures on employees continues, due to public sector hiring freeze

Real seasonally adjusted expenditures on employees went down in the period April-July (by 3%) compared with the preceding four-month period, and were by 3.1% lower than in the same period 2013. This is the result of public sector hiring freeze as of January 2014, which generally proved effective, although the Government often derogates from this rule via special decisions. Register of public sector employees gives the Ministry of Finance better insight into dynamics of these expenditures, which also contributed to their reduction. Low wage indexation in April (by 0.5%) did not result in significant real savings because inflation was extremely low (cumulative inflation in the period April-July was at 0.6%).

Expenditures on pension remained unchanged

Expenditures on pensions (real seasonally adjusted) in the period April-July remained unchanged relative to the preceding four-month period and to the same period last year. This is the result of low pension indexation (which pushed down expenditures on pensions by 0.1%) and a slight increase in the numbers of pensioners.

Fiscal trends by government levels

Central government runs budget deficit and other government levels are in surplus – probably seasonally

Q2 2014 saw continuation of the trend detected in 2013 – central government ran budget deficit and other government levels (Health Insurance Fund of the Republic of Serbia, Autonomous Province of Vojvodina and local self-governments) were running surplus. Local self-governments posted the largest budget surplus (totalling about RSD 3.5 billion in Q2, and RSD 8 billion in the first six months), partly because great investments in large cities (Belgrade, Novi Sad etc.) were stopped. However, we think that this disequilibrium is mainly caused by seasonal factors, and that this surplus will vanish in the second half of the year.

Central government revenues and revenues collected by the Health Insurance Fund of the Republic of Serbia are rising, and local government revenues are falling

Central government revenues and revenues collected by the Healt Insurance Fund of the Republic of Serbia went up moderately in Q2 2014 relative to the same period last year (by 6% and 2.3% respectively), while revenues collected by local self-governmets fell considerably (by 9.7%). This rise in central government revenues came from a steep increase in revenues from corporate income tax caused by changes in tax calendar. The y-o-y decrease in local government revenues occurred because revenues from wage tax (tax rate on wages was reduced in June 2013) and non-tax revenues (construction land use fee was abolished since January 2014) fell sharply, revenues from property tax rose due to new calculation method, and possibly because local self-governments increased their efforts towards more efficient collection of own source public revenues.

Table T6-7. Serbia: Fiscal surplus (deficit) at different levels of government (bn. RSD, current prices)

Year	*Budget of Republic*	*Pension fund*	*National Employment Service*	*Health fund*	*Vojvodina budget*	*Localself-governments*
2010	-108.0	-1.0	-0.1	1.9	-9.6	-11.5
2011	-144.3	0.2	1.3	2.1	-0.7	-15.6
2012	-213.0	-0.4	0.8	4.0	1.1	-0.3
2013	-194.4	-1.2	-0.5	8.7	1.3	6.3
Q1 2014	-78.0	0.3	0.0	6.1	1.8	4.5
Q2 2014	-51.9	0.9	0.8	3.0	2.1	3.5

Source: *QM* calculations based on the Ministry of Finance's data

Moderate rise in central government expenditures, and considerable reduction in expenditures at the local level

Q2 2014 saw a real y-o-y rise in central government expenditures (by 2.7%) driven by increase in expenditures on goods and services, subsidies and capital expenditures. The Health Insurance Fund of the Republic of Serbia spent more than in Q2 2013 (by 2.7%) due to rise in expenditures on goods and services. Sharp drop in local self-government revenues led to consequential decrease in expenditures at this government level by 26.1% in Q2 2014 relative to the same period last year. Reductions were recorded on all items on expenditure side. However, capital expenditures suffered the largest cut, while expenditures on wages were reduced slightly, which is economically unjustifiable. Reduction in expenditures on goods and services (by 20.4%) and subsidies (by 31.7%) at the local level is necessary and justifiable so long as it does not jeopardize functioning of local self-governments.

Trends in public debt

Serbia's public debt stood at EUR 20.9 billion (67.1% of GDP) at the end of July 2014

Serbia's public debt grew by EUR 430 million in the period April-July 2014 and stood at EUR 20.9 billion (about 67.1% of GDP). This increase came from the rise in direct debt, while the downwards trend in indirect debt (detected at the end of 2013) continued. Public debt-to-GDP ratio worsened in this period (by 1.7% of GDP) primarily due to rise in absolute amount of public debt and small real appreciation of dinar exchange rate (by 0.5%), and GDP shrinking. Increase in public debt in the period April-July exceeded fiscal deficit in this period (EUR 320 million). Loan worth EUR 800 million (about 2.6% of GDP) received from the United Arab Emirates in August considerably increased public debt at the end of the month relative to the preceding month, and pushed up government deposits (see: Monetary flows and policy).

Table T6-8. Serbia: Public debt[1] 2000-2014

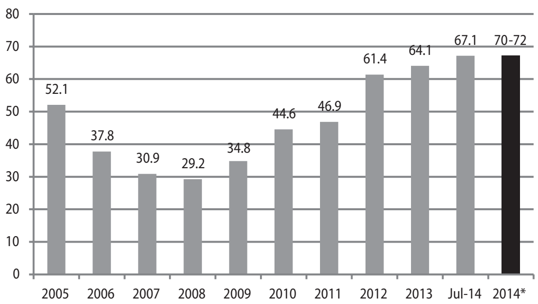
	Amount at the end of period, in billions EUR												
	2000	2005	2006	2007	2008	2009	2010	2011	2012	2013	Q1 2014	Q2 2014	Jul-14
I. Total direct debt	14.17	9.62	8.58	8.03	7.85	8.46	10.46	12.36	15.07	17.3	17.7	18.0	18.3
Domestic debt	4.11	4.26	3.84	3.41	3.16	4.05	4.57	5.12	6.5	7.0	7.5	7.7	7.8
Foreign debt	10.06	5.36	4.75	4.62	4.69	4.41	5.89	7.24	8.6	10.2	10.3	10.3	10.5
II. Indirect debt	-	0.66	0.80	0.85	0.93	1.39	1.71	2.11	2.60	2.81	2.8	2.7	2.7
III. Total debt (I+II)	**14.17**	**10.28**	**9.38**	**8.88**	**8.78**	**9.85**	**12.17**	**14.47**	**17.67**	**20.1**	**20.5**	20.7	20.9
Public debt / GDP[2]	**169.3%**	**50.2%**	**36.2%**	**29.4%**	**25.6%**	**31.3%**	**41.5%**	**45.1%**	**59.3%**	**63.8%**	**62.3%**	**63.0%**	**64.3%**
Public debt / GDP (QM)[3]	**169.3%**	**52.1%**	**37.8%**	**30.9%**	**29.2%**	**34.8%**	**44.6%**	**46.9%**	**61.4%**	**64.1%**	**65.4%**	**65.7%**	**67.1%**

Source: Ministry of Finance's data and QM calculations

Reduction in government guarantees, but they are expected to rebound in the second half of the year

Downwards trend in indirect debt continued and at the end of July it was by EUR 140 million smaller than in Q2, which is considered favorable. However, indirect public debt decreased because government guaranteed loans granted to large borrowers (Srbijagas, Železara, etc.) in 2013 were sufficient to cover their operations in the first half of 2014. Since in the meanwhile no measures intended to eliminate key generators of debt in these companies (financial and business consolidation of Srbijagas, privatization or closing down of Železare, etc.) have been taken, it is likely that indirect debt will rebound by the end of the year because these companies will have to borrow further to cover their current operations, meaning that the government will have to issue guarantees to enable them to do so. This suggests that urgent financial and business consolidation of state-owned and public companies is one of the crucial measures for fiscal consolidation. This primarily means that a firm budget constraint based on the principle „user pays" has to be set, cost efficiency should be achieved through increased labor productivity (reduction in the numbers of employees), management should be professionalized (Srbijagas, Železnice, EPS), and some of these companies should be privatized or declare bankruptcy (Železara Smederevo, Rudnik Resavica, etc.).

Graph T 6-9: Trends in public debt in Serbia (GDP %)



Source: *QM* calculations

Public debt will amount to 70-72% of GDP at the end of 2014, or even more

Based on the projection of 2014 fiscal deficit at more than 8% of GDP, and with other indicators unchanged (slight decrease in GDP, inflation rate below the projected level, real dinar exchange rate unchanged), 2014 public debt is estimated at 70-72% of GDP. Some events could even push public debt above this projection. One such event would be issuance of a large amount of government guarantees on loans to EPS needed to finance import of electricity and its current operations. Additionally, if positive developments in international financial market continue during the autumn and interest rates on Serbian bonds remain quite low, like during the summer, it will be reasonable to issue euro-denominated bonds to obtain funds that would be used to finance fiscal deficit by the end of 2014 and in the first half of 2015. This would also push up the level of public debt by the end of the year.

Prilozi

Annex 1. Serbia: Consolidated General Government Fiscal Operations[1)], 2008-2014 (nominal amounts, bn RSD)

	2008	2009	2010	2011	2012					2013					2014	
					Q1	Q2	Q3	Q4	Q1-Q4	Q1	Q2	Q3	Q4	Q1-Q4	Q1	Q2
I PUBLIC REVENUES	**1,145.9**	**1,146.5**	**1,223.4**	**1,302.5**	**312.6**	**339.7**	**355.1**	**398.0**	**1,405.4**	**330.0**	**362.4**	**369.1**	**406.4**	**1,467.8**	**336.7**	**464.4**
1. Current revenues	1,143.1	1,139.2	1,215.7	1,297.9	311.7	337.7	354.0	390.4	1,393.8	327.3	361.3	367.6	405.0	1,461.3	335.5	461.9
Tax revenue	1,000.4	1,000.3	1,056.5	1,131.0	276.3	298.1	315.6	335.9	1,225.9	296.4	321.8	325.8	352.5	1,296.4	301.9	417.1
Personal income taxes	136.5	133.5	139.1	150.8	35.8	41.2	41.4	46.7	165.3	38.2	39.8	35.9	42.1	156.1	32.2	44.6
Corporate income taxes	39.0	31.2	32.6	37.8	22.9	10.9	10.3	10.7	54.8	18.4	11.0	15.4	15.8	60.7	15.5	21.1
VAT and retail sales tax	301.7	296.9	319.4	342.4	79.7	90.1	94.4	103.3	367.5	87.3	98.7	94.6	99.9	380.6	93.6	128.9
Excises	110.1	134.8	152.2	170.9	34.6	40.6	54.9	51.0	181.1	42.5	53.7	52.3	56.3	204.8	42.9	60.0
Custom duties	64.8	48.0	44.3	38.8	7.7	9.0	9.3	9.8	35.8	7.3	7.9	8.2	9.1	32.5	7.2	9.9
Social contributions	312.7	318.8	323.0	346.6	85.9	94.6	94.5	103.9	378.9	93.4	99.7	107.7	117.6	418.3	99.8	137.9
Other taxes	35.6	37.1	46.0	43.5	9.7	11.7	10.8	10.4	42.6	9.3	10.9	11.6	11.7	43.5	10.7	14.7
Non-tax revenue	142.7	138.8	159.2	166.9	35.4	39.6	38.4	54.5	167.9	30.9	39.6	41.9	52.5	164.9	33.6	44.8
2. Capital revenues	1.4	0.9	0.3	2.0	0.6	1.3	0.8	6.0	8.7	1.9	0.5	0.6	0.5	3.5	0.4	1.5
	0.0															
II TOTAL EXPENDITURE	**-1,195.7**	**-1,248**	**-1,329.9**	**-1,435.9**	**-362.8**	**-391.1**	**-389.2**	**-463.1**	**-1,606.2**	**-364.3**	**-402.6**	**-422.1**	**-445.0**	**-1,633.9**	**-397.2**	**-537.4**
1. Current expenditures	-1,089.6	-1,155	-1,224.8	-1,324.8	-337.5	-368.6	-359.3	-414.6	-1,479.9	-350.9	-385.0	-395.4	-418.6	-1,549.8	-383.4	-517.2
Wages and salaries	-293.2	-302.0	-308.1	-342.5	-85.5	-94.4	-91.2	-103.6	-374.7	-93.8	-98.1	-97.5	-103.4	-392.7	-92.5	-126.9
Expenditure on goods and services	-181.2	-187.4	-202.5	-216.3	-51.2	-62.9	-53.8	-67.7	-235.7	-49.7	-55.3	-60.0	-71.9	-236.9	-55.2	-75.2
Interest payment	-17.2	-187.4	-34.2	-44.8	-15.4	-13.4	-23.3	-16.2	-68.2	-18.9	-27.5	-27.2	-20.9	-94.5	-35.5	-45.7
Subsidies	-77.8	-22.4	-77.9	-80.5	-22.6	-25.2	-19.6	-44.2	-111.5	-19.0	-22.0	-28.4	-31.8	-101.2	-19.4	-25.6
Social transfers	-496.8	-63.1	-579.2	-609.0	-154.9	-161.1	-163.5	-173.0	-652.5	-162.4	-173.0	-172.6	-179.5	-687.6	-170.6	-228.7
o/w: pensions5)	*-331.0*	-556.4	*-394.0*	*-422.8*	*-112.5*	*-117.8*	*-119.2*	-124.1	-473.7	-120.0	-124.6	-125.3	-128.2	-498.0	-125.0	-167.6
Other current expenditures	-23.5	-387.3	-22.9	-31.7	-7.9	-11.7	-8.0	-9.8	-37.4	-7.1	-9.1	-9.6	-11.1	-36.9	-10.2	-15.1
2. Capital expenditures	-106.0	-24.0	-105.1	-111.1	-25.3	-22.5	-30.0	-48.6	-126.3	-13.4	-17.6	-26.7	-26.4	-84.0	-13.8	-20.2
III "OLD" DEBT REPAYMENT, GOVERNMENT NET LENDING AND RECAPITALIZATIONS	**-19.1**	**-20**	**-29.9**	**-24.9**	**-4.7**	**-5.7**	**-2.3**	**-3.9**	**-16.6**	**-3.1**	**-3.9**	**-4.1**	**-1.6**	**-12.7**	**-5.2**	**-8.4**
IV TOTAL EXPENDITURE, GFS (II+III)	**-1,214.8**	**-1,268.3**	**-1,359.8**	**-1,460.8**	**-367.5**	**-396.7**	**-391.6**	**-467.0**	**-1,622.8**	**-367.3**	**-406.5**	**-426.1**	**-446.6**	**-1,646.5**	**-402.5**	**-545.9**

Source: *QM*

Annex 2. Serbia: Consolidated General Government Fiscal Operations[1)], 2008-2014 (real growth rates)

	2008	2009	2010	2011	2012					2013					2014		
					Q1	Q2	Q3	Q4	Q1-Q4	Q1	Q2	Q3	Q4	Q1-Q4	Q1	Q2	Q1-Q2
I PUBLIC REVENUES	**3.3**	**-8.7**	**-1.5**	**-4.6**	**1.7**	**4.8**	**-0.8**	**-3.2**	**0.6**	**-5.8**	**-3.2**	**-2.7**	**0.1**	**-3.0**	**-0.6**	**4.5**	**1.9**
1. Current revenues	3.5	-9.1	-1.5	-4.4	1.7	4.5	-0.9	-4.4	0.1	-6.2	-2.9	-2.8	1.7	-2.6	-0.1	4.3	2.1
Tax revenue	3.7	-8.8	-2.5	-4.1	1.9	5.3	1.9	-4.4	1.0	-4.2	-2.1	-3.4	2.9	-1.7	-0.8	6.4	2.8
Personal income taxes	6.3	-10.8	-3.9	-2.9	4.6	4.6	1.3	-1.6	2.1	-4.9	-12.3	-18.9	-11.6	-12.2	-17.8	-13.5	-15.6
Corporate income taxes	18.5	-27.0	-3.6	3.9	51.5	39.9	25.4	15.0	35.1	-28.2	-7.9	39.6	44.9	2.9	-18.0	165.3	50.5
VAT and retail sales tax	2.5	-10.2	-0.7	-4.0	-4.0	6.9	0.9	-3.7	0.0	-2.1	-0.6	-6.2	-5.2	-3.8	4.3	-3.6	0.1
Excises	0.7	11.6	4.2	0.6	-5.7	-3.0	8.5	-7.0	-1.2	9.5	20.1	-10.9	8.2	5.1	-1.7	0.8	-0.3
Custom duties	1.8	-32.4	-14.9	-21.5	-18.6	-8.6	-11.4	-17.6	-14.0	-15.3	-20.5	-16.9	-9.3	-15.6	-4.4	-7.0	-5.8
Social contributions	4.3	-7.0	-6.5	-3.9	4.8	6.1	0.7	-3.4	1.9	-3.0	-4.4	6.7	10.9	2.6	4.2	29.1	21.2
Other taxes	-2.3	-4.9	14.5	-15.2	-9.7	7.6	-12.0	-19.2	-8.8	-14.2	-15.6	0.2	10.2	-5.2	12.5	8.2	5.9
Non-tax revenue	2.6	-11.3	5.8	-6.1	0.1	-1.1	-19.0	-4.3	-6.2	-22.0	-9.4	2.1	-5.4	-8.7	5.8	-13.0	-4.7
2. Capital revenues	-76.8	-41.4	-66.8	468.2	124.1	259.1	176.7	373.3	304.5	159.4	-63.6	-31.7	-91.3	-63.0	-79.6	17.6	-58.5
II TOTAL EXPENDITURE	**4.5**	**-4.8**	**-1.7**	**3.3**	**10.3**	**9.2**	**-2.9**	**1.5**	**4.3**	**-10.4**	**-6.6**	**1.5**	**-5.8**	**-5.5**	**6.2**	**2.2**	**3.9**
1. Current expenditures	6.9	-3.3	-2.2	3.1	8.2	9.3	-1.7	1.4	4.1	-7.2	-5.2	3.0	-1.0	-2.7	6.4	0.4	3.0
Wages and salaries	10.9	-6.0	-5.9	0.4	6.6	6.3	-5.7	1.4	2.0	-2.1	-5.7	0.0	-2.1	-2.6	-3.9	-2.0	-1.3
Expenditure on goods and services		-5.7	-0.3	4.3	9.4	15.0	-2.3	-11.4	1.5	-13.4	-20.3	4.5	4.0	-6.6	8.2	3.4	1.7
Interest payment	-2.8	-5.7	-0.3	17.4	48.1	6.6	93.4	23.4	41.9	9.8	86.3	9.5	26.7	28.8	82.9	2.2	35.2
Subsidies	-13.3	19.0	40.6	7.4	42.6	56.4	-36.2	82.9	29.1	-24.7	-20.7	35.9	-29.5	-15.6	-0.7	6.0	2.8
Social transfers	10.1	-26.0	13.9	5.8	3.8	2.9	-0.3	-6.1	-0.1	-6.4	-2.5	-1.2	1.7	-2.1	2.3	-2.2	0.0
o/w: pensions5)	*9.5*	2.2	-3.9	3.9	*8.4*	*7.4*	*3.1*	*-0.5*	*4.4*	*-4.8*	*-4.1*	*-1.6*	*1.2*	*-2.3*	*1.5*	*0.0*	*0.8*
Other current expenditures	14.9	6.7	-6.1	23.9	-17.1	36.8	12.2	11.8	9.9	-19.6	-29.5	12.4	10.6	-8.4	39.8	36.2	33.9
2. Capital expenditures	-4.3	-6.7	-11.8	5.3	48.7	8.3	-14.9	2.3	6.0	-52.9	-29.0	-16.6	-46.7	-38.2	0.9	41.5	24.1
III "OLD" DEBT REPAYMENT, GOVERNMENT NET LENDING AND RECAPITALIZATIONS	**12.3**	**-2.4**	**35.2**	**-25.6**	**-18.3**	**-45.2**	**-54.7**	**-26.3**	**-37.9**	**-41.7**	**-37.6**	**63.2**	**-58.5**	**-29.0**	**66.6**	**45.4**	**54.7**
IV TOTAL EXPENDITURE, GFS (II+III)	**4.6**	**-4.8**	**-1.1**	**-3.8**	**9.8**	**7.7**	**-3.5**	**1.2**	**3.6**	**-10.8**	**-7.0**	**1.8**	**-6.2**	**-5.7**	**6.7**	**2.6**	**4.3**

Source: *QM*

Annex 3. Serbia: Real annual rates of growth in public revenues and public expenditures, by the levels of government

	Q2 2014/Q2 2013			
	Consolidated budget	Budget of Republic	Health Fund	Local self-governments
A Total public revenues (I)+(II)+(III)+(IV)	**4.5**	**6.0**	**2.3**	**-9.7**
I Current revenues (1)+(2)	4.3	6.0	2.4	-10.8
1. Tax revenues	6.5	6.4	2.8	-2.8
1.1. Customs	-7.0	-7.0	-	-
1.2. Personal income tax	-13.4	-12.0	-	-14.2
1.3. Corporate income tax	165.5	172.1	-	-
1.4. VAT	-3.5	-3.5	-	-
1.5. Excise duties	0.9	0.9	-	-
1.6. Property taxes	42.9	-	-	42.9
1.9.Other taxes	29.2	12.6	-	14.3
1.10. Social security contributions	8.23	-	2.8	-
2. Non-tax revenues	-13.0	3.1	-12.9	-36.1
II Capital revenues	17.64	-	63.6	16.7
III Transfers from the other levels of government	-	-	2.1	-7.4
IV Donations	117.7	72.1	-	47.9
B Total public expenditures (I)+(II)+(III)+(IV)	**2.2**	**5.5**	**2.7**	**-26.1**
I Current expenditures	0.4	0.8	2.9	-19.8
1.1 Wages	-2.0	-2.3	-0.9	-12.2
1.2. Goods and services	3.5	20.7	5.9	-20.4
1.3 Interest payments	2.3	3.1	-88.6	-1.7
1.4 Subsidies	6.0	32.0	0.0	-31.7
1.5 Social insurance and social assistance	-2.1	-7.9	30.5	-23.2
1.6 Transfers to the other levels of government	0.0	-4.9	-	-
1.7 Other current expenditures	36.3	35.4	86.7	-21.8
II Capital expenditures	41.6	148.7	-88.9	-59.3
III Strategic reserves	0.0	2223.4	-	-72.6
IV Net lending	45.5	50.8	-	-5.7

Source: *QM*