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FISCAL CONSOLIDATION AND GROWTH IN SERBIA, 2015-2017: PROGRAM, ACCOMPLISHMENTS AND DRIVERS

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Abstract

Despite the encouraging progress in economic and fiscal trends in 2015 and 2016, Serbia is still far from high economic growth and healthy public finances. In this paper, we provide an in-depth analysis of the drivers of the economic recovery and the fiscal deficit decrease in the previous two years. In both cases, the analyses have shown that the observed improvements rest, to a large extent, on short-term and unplanned factors that are easily exhausted. Economic activity was under a significant impact of external growth drivers – a strong drop in oil and food prices, decreased interest rates and faster recovery of the region and the Eurozone. This is why practically all countries in the region, and not just Serbia, exceeded GDP forecasts by about 1 p.p. in 2015 and 2016. The fiscal deficit was decreased primarily through a surprisingly high public revenue collection, while for the most part, the planned savings were not achieved. Fiscal risks, particularly those pertaining to poor business performances of public and state-owned enterprises, practically remain the same in 2017 as they were in 2014. All this indicates that the improved economic and fiscal trends leave no room for complacency, but should be observed as a rare opportunity to implement structural reforms in a somewhat more favourable environment without a direct pressure of an impending crisis. If this opportunity is missed now, the reforms will have to be implemented in a far less favourable environment and will thus be far more difficult.

Key words: public debt, fiscal consolidation, fiscal deficit, tax collection, forecast errors, external drivers, investments

1. Introduction and Main Findings

Despite the encouraging progress in economic and fiscal trends in 2015 and 2016, Serbia is still far from high economic growth rates and well-organized and healthy public finances. In this paper, we provide an in-depth analysis of the drivers of the economic recovery and the fiscal deficit decrease from the previous two years. In both cases, the analyses have shown that the observed improvements rest, to a large extent, on short-term and unplanned factors that are easily exhausted. Economic activity was under a significant impact of external growth drivers in the last two years – a strong drop in oil and food prices, decreased interest rates for Euro-based loans and faster recovery of the region and the Eurozone. This is why practically all countries in the region, and not just Serbia, experienced GDP growths exceeding forecasts by about 1 p.p. of GDP in 2015 and 2016. The fiscal deficit was decreased primarily through a surprisingly high public revenue collection, while the planned savings were not achieved, for the most part. Fiscal risks, particularly those pertaining to poor business performances of public and state-owned enterprises, practically remain the same in 2017 as they were in 2014. All this indicates that the improved economic and fiscal trends leave no room for complacency, but should be observed as a rare opportunity to implement structural reform measures in a somewhat more favourable environment and without a direct pressure of an impending crisis. If this opportunity is missed now, the reforms will have to be implemented in a far less favourable environment and will thus be far more difficult.

In the first chapter, we analyzed economic growth drivers in Serbia in the last two years and GDP growth perspectives for 2017 and medium term. In 2016, Serbia achieved a GDP growth of 2.7%, the highest since the crisis of 2008 erupted. However, comparative analysis shows that other countries in the region have also enjoyed record-breaking growth in the post-crisis period, except that their growth was, on average, higher than Serbia's and amounted to 3.6%. Another common feature for almost all the observed countries, including Serbia, is that they achieved a far greater economic growth in 2015 and 2016 than forecasted. In Croatia, for example, GDP growth in 2015 was forecasted at 0.2%, while the achieved growth reached 1.6%; GDP growth in Romania in 2015 reached 3.7% instead of the expected 2.7%; in Hungary, it was 3.1% instead of 2.4% and in Bulgaria, instead of 0.8% which was forecasted, the achieved GDP growth reached as much as 3.6%. Similar positive deviations from forecasts reoccurred in 2016. This unexpected economic growth increase in almost all countries in the region indicates that domestic economic policy is not the only factor affecting the economic growth acceleration – but rather that this faster economic growth was also due to some favourable circumstance at the international level, which was not a part of the planned economic policies (drop in the price of commodities, especially oil and gas, interest rate decrease in Europe and a faster recovery of the Eurozone and the region).

Additional confirmation and quantitative qualification of the assumption that the unusually high economic growth in the countries in the region in 2015 and 2016 was strongly influenced by favourable circumstances on the international stage, was found in the uniform pattern in which individual GDP components in the countries in the region deviated from initial forecasts. The idea for this analysis came from a paper by Blanchard and Leigh (2013), in which the regular pattern in economic growth forecast errors for developed countries was used to assess their fiscal multipliers. In that paper, the deviation of the achieved growth from the forecasts was attributed to an unexpectedly large impact of fiscal consolidation on GDP. We believe that the reasons behind a systemic, positive deviation of GDP growth and its components from the forecasts in the countries in the region lie in the effects of unplanned external circumstances on all observed economies. Economic growth in the countries in the region in 2015 and 2016 exceeded forecasts due to an unexpected acceleration in real private consumption growth, by 1.7% compared to forecasts. However, the real private consumption growth did not spill over entirely to GDP growth acceleration, as a part of this larger consumption was covered by increased imports and not just by increased domestic production. In assessing the impact of the GDP components that showed a systemic forecast error in 2015 and 2016, we can say with great certainty that the influence of external factors on economic growth acceleration in the region in the previous two years amounted to about 1 p.p.

Unlike in the region, it seems that there were two trends simultaneously driving the economic growth in Serbia during 2015 and 2016. A relatively successful implementation of fiscal consolidation, which brought about macroeconomic stability with the reformed Labour Law, Law on Planning and Construction etc., probably contributed to Serbia catching up to a certain extent to the economic growth of the countries in the region.

However, the achieved growth in Serbia in 2015 and 2016 would most likely be about 1 p.p. lower, just like in the countries in the region, had it not been surprisingly accelerated by the favourable international factors.

Sooner or later the favourable international circumstances are bound to change, but Serbian economy is still not meeting the requirements for a high economic growth without the assistance of favourable external drivers. Another information that points out the structural weaknesses of Serbian economy which stand in the way of high GDP growth rates is the fact that since the end of the first wave of the world economic crisis of 2008, Serbian economic growth has been significantly lagging behind other comparable countries. Average GDP growth in Serbia in the period 2010-2016 was about 0.5%, while, at the same time, the average economic growth in CEE countries amounted to 2.5% and of the countries in the region, about 2%. Of all the CEE countries, only Croatia recorded a lower economic growth than Serbia in the last seven years.

The main structural obstacle to high and sustainable GDP growth rates in Serbia comes from extremely low share of investments in GDP of about 18%, which is among the lowest in the entire Central and Eastern Europe. To ensure high and sustainable GDP growth, share of investments in Serbian GDP would have to increase, at least, to the regional average of about 23% and probably more. The analysis shows that there are several different issues keeping the share of investments in the GDP at such a low level. The largest part of the gap between the actual and the needed investment level in Serbia (about 3% of GDP), of about 3% of GDP, pertains to the investments of the private sector. Insufficient private sector investments, by all accounts, are the result of a poor investment climate, also indicated by the low ranks Serbia holds in all relevant international research studies (WB, WEF, Transparency International). Within private sector investments, there are indications that domestic small and medium enterprises and entrepreneurs seem to be suffering the most, as they are the ones most affected by the poor business climate in Serbia. In addition to insufficient investments from the private sector, the government is also implementing public investments both inefficiently and insufficiently; they would have to increase by at least 1% of GDP. To add to that, poor management of public and state-owned enterprises has led to their investments falling short of the necessary level by at least 1% of GDP as well.

It would therefore be necessary to use this period of favourable international circumstances to implement comprehensive reforms and measures aimed at increasing investments. In terms of public investments, in addition to large capital projects (the realization of which is improving), more attention needs to be paid to the investments into local infrastructure which are often not as prominent in the public discussions (access to clean drinking water, sewer system, waste water treatment etc.). In the segment of public enterprises, low investments from *EPS* present a special cause for concern (they are kept at a level lower than the depreciation) since a lack of energy capacities could have long-term negative consequences on the country's economic growth. Delays in the resolution of the fate of state-owned enterprises, spanning several years, lead to this significant share of Serbian economy investing next to nothing. In some cases, the lack of investments from state-owned enterprises can also represent an environmental issue (rehabilitation of the tailings pond in copper mine company *RTB Bor*, for example). Finally, the largest influence of the Government on the increase of investment would have to be indirect, through the improvement of the bad business climate. In improving the investment climate, special attention should be paid to the issues of the rule of law and corruption, since Serbia has been rated particularly poorly in these indicators, by all relevant international institutions.

In the second chapter, we analyzed the results of 2015-2017 fiscal consolidation, which had two fundamental objectives: *first*, to reign in the uncontrolled public debt growth (and neutralize the direct danger of a public debt crisis); and the *second*, to successfully reform public finance in Serbia and thus set it firmly on a path that is sustainable in the long run. To meet the first objective, the Government planned to decrease the fiscal deficit from 6.6% of GDP in 2014 to 3.8% of GDP in 2017, which was supposed to stabilize the public debt at the level of about 78% of GDP at the end of the period. Even though we are just at the beginning of the last year covered by the initial plan, it is clear that this specific fiscal objective is practically already fulfilled, and even surpassed. The general government deficit in 2017 should amount to 1.7 % of GDP, which is by about 750 Mln Euros less than planned at the end of 2014. In addition, the public debt growth was stopped already in 2016 and the latest forecasts indicate that it will amount to about 73% of GDP at the end of 2017 – which is a whooping 5 p.p. of GDP, or 1.8 Bln Euros less than envisaged. However, what casts a shadow over these indisputable fiscal improvements is the

fact that less than a modest progress has been made in the implementation of the reform part of the fiscal consolidation (primarily the reform of public and state-owned enterprises). Successful implementation of the reform was supposed to ensure a significant improvement in the structure of public expenditures and adjust their level to the strength of the national economy, to reduce future fiscal risks and support a high and sustainable economic growth in the medium and long term – but our analyses show that for the large part this has not yet occurred.

The fiscal consolidation of 2015-2017 would surely have failed had it truly relied on the expenditure austerity measures (from the 2014 plan), which were aimed at decreasing the excessive public expenditures (and rightly so). Namely, only a little over a half of the initially planned savings have been achieved, which is why the public expenditures will exceed the initial plan by about 650 Mln Euros in the last year of the programme implementation. General government downsizing was particularly unsuccessful, as it is likely that not even a third of the planned savings will be achieved – even though the number of employees was supposed to be decreased by 75,000, the latest data show that the actual decrease was a mere 17,000. The savings from the planned salary and pension freeze in the period of 2015-2017 have not been achieved, either. Not only has the decision on the salary and pension freeze already been suspended twice (in 2016 and 2017), but the expected savings from the decrease of salaries and pensions in real terms were further decreased by the fact that the inflation remained far below the forecast throughout the entire period. Due to insufficient implementation of the planned austerity measures on the expenditure side, the structure of public expenditure will deviate significantly in 2017 from what was originally planned (and optimal). Some of the basic budget imbalances are still present: although decreased, wage and pension bill still exceeds the sustainable level, subsidies will be larger by about 1 p.p. of GDP than in comparable countries, while public investments are insufficient and should be increased by at least 1 p.p. of GDP.

However, the fiscal consolidation was actually rescued by a surprisingly good public revenue collection, exceeding the initial forecast by 1.4 Mln Euros in 2017 – which makes up more than enough for all the missed saving opportunities. The largest contribution to such a strong public revenue growth comes from a more efficient tax collection (700-800 Mln Euros), due to well targeted *ad hoc* grey economy suppression measures, implemented by the Tax Administration in the field. In addition, a better than forecasted macroeconomic environment, especially the more favourable labour market trends, will lead to an increase in social contribution revenue of about 400-500 Mln Euros above the plan. Finally, non-tax revenues also increased by about 200 Mln Euros in 2017, relative to the plan, due to increased transfers from public and state-owned enterprises into the budget, on the grounds of the made profit – which are questionable from the view point of economic justifiability. Having in mind the magnitude of the operational issues some of these enterprises face (such as EPS or Telekom), the short-term benefit that the government is to achieve from the increased withdrawal of their liquid funds, could be smaller than the damage that could arise if these enterprises are excessively financially drained.

Contrary to the original intentions, practically 50% of the permanent fiscal deficit decrease has been achieved through unplanned public revenue growth and, to a lesser extent, some non-systemic savings in public expenditures – the sustainability of which will still be in question if they are not supported by reforms. Namely, the tax collection increase was achieved with the existing (inadequate) Tax Administration capacities: average age of employees is unfavourable, there is an insufficient number of tax inspectors, analytical capacities are weak, organisational structure and information system are outdated etc. This is why we believe that there is a pronounced risk that the achieved collection rate will not be maintained without the modernization of the Tax Administration. Even though unsuccessful general government downsizing, certain savings have been achieved nevertheless, due to natural outflow of the retiring employees combined with the employment ban. Moreover, previous attempts to decrease the number of general government employees (IMF arrangements 2002-2006 and 2009-2010) have shown that most often these effects were only short-lived. Statistics show that soon after the arrangements ended the number of general government employees bounced back to the previous level, or even exceeded it. To prevent similar situations from repeating in the following years, it is necessary to initiate a reform of the largest public systems, primarily healthcare and education as soon as possible. One of the outcomes of these reforms would be a clearly defined number and structure of the employees needed, which would prevent an excessive and unjustified increase in employment once the employment ban has been lifted.

Fiscal risks are threatening to annul all that has been accomplished thus far, as other reform goals have not been met as well. This is especially true for the reform of public enterprises and the completion of privatization of state-owned enterprises as it is seriously overdue, even though it was one of the main objectives of the initiated fiscal consolidation. *Serbian Railways* are practically the only public enterprise in which necessary measures have been undertaken: the enterprise has been divided into four independent companies, a new manner of subsidizing increases efficiency, a large downsizing has been planned etc. There are certain problems and delays in the implementation of the planned reform measures, but despite this, *Serbian Railways* are the public enterprise that has went the furthest in the restructuring process. On the other hand, essential reforms of the *EPS* have been delayed for years, even though the enormous debt of this enterprise (in excess of 1 Bln Euros), which could fall to the budget, represents the largest fiscal risk. *Srbijagas's* performance depends directly on the resolution of problems in enterprises that are failing to pay for the delivered gas (petrochemical companies *Petrohemija, Azotara, MSK* and others), which has not yet occurred, so these companies continue to accumulate debt. Therefore, it is probably a matter of time before Srbijagas runs into liquidity problems again, which will require the issue of new guarantees for loans – regardless of the fact that the government has explicitly undertaken not to do that anymore. Finally, after the first and encouraging wave of resolving the status of enterprises undergoing privatization in 2015, it seems that the process has ground to a halt in 2016 (with the exception of the sale of the steel mill *Železara Smederevo* to the Chinese company *Hesteel*). There are no sustainable solutions on the horizon for the remaining enterprises from this group (copper mine *RTB Bor*, pharmaceutical company *Galenika*, agricultural corporation *PKB*, coal mine *Resavica*, furniture company *Simpo* and others), so the fiscal risk from their poor business performances keeps increasing.

When it is all summed up, it is important to note, once again, that the fiscal consolidation of 2015-2017 successfully resolved some acute issues in Serbian public finances – a high deficit of 2014 was decreased more than it was originally planned, while the strong growth of public debt was stopped a year earlier than expected. However, with the public debt currently reaching about 75% of GDP, Serbia is still a highly indebted country – a single external "shock" would be sufficient to bring it back to the brink of a public debt crisis. In order to lower the public debt to a safer level (about 50% of GDP), additional savings have to be made which would lower the deficit to 0.5% of GDP and maintain it at that level in the long run. Our analysis shows that this can be achieved in an economically desirable manner. It would be necessary to keep decreasing total public expenditures and achieve a fiscal balance at a level lower than the present 44-45% of GDP, with fine-tuning the structure of public spending (increase in public investments combined with a decrease of, e.g. subsidies). Together with a Tax Administration reform that would allow additional improvements in public revenue collection, this would open up some room for incentives to economic growth through a moderate reduction of the tax burdens on the economy.

2. Economic growth in Serbia: External vs. Internal drivers

Serbian economic growth cannot be observed in isolation from the economic trends in the region. In 2015 and 2016, growth in the countries in the region reached the highest value since the outbreak of the 2008 crisis, amounting to about 3.5%, on average. A larger economic growth in the region also had a positive effect on Serbian economy, as economies in the region are closely connected (Serbia places a third of its export into the countries in the region). In this chapter, we analyzed the reasons behind the accelerated growth in the region (and in Serbia) in the last two years. Comparative analysis has shown that the countries in the region enjoyed a strong positive effect from external drivers, which increased their economic growth in the last two years by about 1 p.p. on average. These favourable exogenous economic growth drivers were a sudden drop in food and oil prices, low interest rates and Eurozone recovery.

Since the outbreak of the crisis, Serbian economic growth has been lagging well behind the average growth, not only among the countries in the region, but in the entire CEE as well. The reasons for the lag can be found in internal structural problems of the Serbian economy, reflected in the extremely low share of investments in the GDP of about 18%. On the other hand, average share of investments in the GDP in the CEE countries is 22%, and in the countries in the region, almost 23%. Low investment share is influenced as well by a poor investment climate, indicated by the poor ranking of Serbia in the relevant studies of competitiveness and corruption (WB, WEF, Transparency International) Due to a poor climate, the private sector in Serbia, and especially small and medium enterprises and entrepreneurs, invest far less than those in other comparable countries. In addition, we discovered that the direct influence of the government on the overall low level of investment, is stemming from insufficient funds being used for public investments, as well as from the poor management of public and state-owned enterprises that, instead of having a positive impact on economic growth, waste their resources and threaten the fiscal stability with their losses and debts.

In the first and most comprehensive section of this chapter, we analyzed economic growth in Serbia in 2015 and 2016 in a regional context. We showed that a significant part of the economic recovery has come from outside, due to favourable effects of international economic drivers. In the second section, we point out the main structural weaknesses of the Serbian economy, which stand in the way of a high and sustainable economic growth. In this section we also discuss the necessary economic policies for a permanent increase of Serbian economic growth.

2.1. Economic growth in Serbia and the region in 2015 and 2016: results exceed expectations under the influence of favourable circumstances at the international level

The preliminary results for 2016 show an economic growth in Serbia of 2.7%, compared to 0.8% in 2015. GDP growth rate of 2.7% in Serbia in 2016 is the largest since the crisis that erupted in the second half of 2008 and, with this growth, the pre-crisis production level has finally been exceeded, after eight years. In addition, in both observed years (2015 and 2016) the achieved GDP growth was far better than initially planned. For 2015, it was expected that the Serbian economy would undergo a mild recession; in 2016, expectations were that it would achieve a 1.5-2% growth, meaning that the achieved growth in both 2015 and 2016 was about 1 p.p. larger than originally forecasted.

However, put into the regional context, the achieved GDP growth in Serbia in the last two years is not as spectacular as it may seem at first glance. GDP trends from 2013 onwards in all countries in the region (and in the Euro zone) are presented in Table 1. The Table shows that Serbian growth in 2016 remained below average in comparison with the neighbouring countries, despite the significant acceleration. This is because the economic activity in the region has shown significant acceleration in 2015 and 2016, compared to 2013 and 2014 and thus the region continues to maintain its advantage over the economic growth in Serbia. With the latest acceleration, the achieved GDP in the countries in the region amounts to about 3.5%, therefore just like Serbia, the region has also experienced a record economic growth since the outbreak of the 2008 crisis.

Table 1: GDP growth in Serbia and in the surrounding countries, 2013-2016

Country	2013	2014	2015	2016[1)]	average growth 2013-2014	average growth 2015-2016
				%		
Serbia	2,6	-1,8	0,8	2,7	0,4	1,8
Neighbouring countries (weighted average)	2,3	2,5	3,3	3,6	2,4	3,4
Albania	1,0	1,8	2,8	3,2	1,4	3,0
Bosnia and Herzegovina	2,4	1,1	3,0	2,0	1,8	2,5
Bulgaria	1,3	1,5	3,6	3,1	1,4	3,4
Croatia	-1,1	-0,4	1,6	2,6	-0,7	2,1
Hungary	1,9	3,7	3,1	2,1	2,8	2,6
FYR Macedonia	2,9	3,5	3,7	2,4	3,2	3,1
Montenegro	3,5	1,8	3,4	2,7	2,7	3,1
Romania	3,5	3,0	3,7	5,2	3,2	4,5
Eurozone	-0,3	1,1	2,0	1,7	0,4	1,9

Source: EU Commission, IMF, statistical offices of the observed countries

1) Assessment of the EU Commission (Autumn Economic Forecast 2016); for BH, the assessment is based on the data of the Statistical Office of Bosnia and Herzegovina because the EU Commission does not publish data for this country; for FYR Macedonia, the growth assessment has been corrected to a higher value because the data of the EU Commission deviates significantly from the data of the Macedonian Statistical Office

The question we now raise is – what was the cause of the acceleration in the economic activity in the region (and in Serbia) during the past two years. The answer is important, as it will determine, to a large extent, the perspectives for regional growth in the upcoming years. One possibility is that the growth acceleration of 2015 and 2016 came only from internal factors in individual countries (structural reforms, increased price competitiveness etc.). In that case, the economic growth acceleration would be sustainable; the growth could even increase further in the upcoming years. The second option is that the economies in the region were spurred on, to a significant degree, by the external factors as well. In such a case, the observed acceleration of economic activity would most likely be limited in duration, as the international circumstances are subject to change.

To ascertain the nature of the economic boom in the region, we used the (modified) basic idea from Blanchard and Leigh (2013) [3]. In that paper, authors investigate the relation between growth forecast errors and fiscal consolidation during the crisis. The authors observed that the achieved GDP growth rates were somewhat lower than forecasted in the developed countries that had implemented stricter fiscal consolidation programmes. They then concluded that the fiscal multipliers in those countries were higher than previously perceived. In this paper, we also analyzed the GDP growth forecast errors, but with a slightly different purpose. Namely, some of the significant external factors that could have influenced economic growth in the region in the last two years came as a surprise – which means they could not have been included in the previous GDP forecasts. This is why a systematic difference between the achieved and the forecast GDP growth should be expected, if such external factors truly did play a significant role. For example, a sharp drop in oil prices in 2015 was not envisaged at the end of 2014, so it could not have been included in the GDP forecasts for 2015. If the oil price drop did not have a significant effect on the economies in the region, differences between the achieved and the forecasted GDP of individual countries in 2015 should be small and random. However, if the low price of oil galvanized economic growth in the region, there should be a common, systemic increase in GDP in 2015 compared to forecasts. More precisely, the GDP components that are not influenced by a low price of oil in the short term (e.g. investments) should not deviate much from the original forecasts, but there should be significant and uniform deviations from the forecast values of those GDP components that the oil price drop could have an impact on (private consumption).

In the last two years, the differences between the achieved and forecasted GDP growth rates in the region were quite pronounced and mostly positive. Serbia, therefore, was no exception in that it achieved growth rates significantly higher than originally forecasted in 2015 and 2016. In Croatia, for example, GDP growth in 2015 was forecasted at 0.2%, while the achieved growth reached 1.6%; in Romania GDP growth in 2015 reached 3.7% instead of the expected 2.7%; in Hungary it was 3.1% instead of 2.4% and in Bulgaria as much as 3.6% instead of

the forecasted 0.8%. Although the data for GDP trends in the region in 2016 are not final yet, they unambiguously show that the described phenomenon of growth acceleration compared to expectations occurred again in 2016, but to a somewhat lesser extent than in 2015. Forecasts and achieved growth rates in the countries in the region are presented in Table 2.

Table 2: GDP forecast errors in Serbia and in the surrounding countries, 2015-2016

Country	Forecasts 2015[1)]	Forecasts 2016[2)]	Growth 2015	Growth 2016[3)]	Forecasts errors 2015	Forecasts errors 2016
			%			*p.p.*
Serbia	-0,3	1,6	0,8	2,7	+ 1.1	+ 1.1
Neighbouring countries (weighted average)	2,2	3,0	3,3	3,7	+ 1.15	+ 0.65
Albania	3,0	3,2	2,8	3,2	- 0.2	0.0
Bulgaria	0,8	1,5	3,6	3,1	+ 2.8	+ 1.6
Croatia	0,2	2,1	1,6	2,6	+ 1.4	+ 0.5
Hungary	2,4	2,1	3,1	2,1	+ 0.7	0.0
FYR Macedonia	3,5	3,3	3,7	2,4	+ 0.2	- 0.9
Montenegro	3,0	4,0	3,4	2,7	+ 0.4	- 1.3
Romania	2,7	4,2	3,7	5,2	+ 1.0	+ 1.0
Eurozone	1,3	1,7	2,0	1,7	+ 0.7	0.0

Source: EU Commission, statistical offices of the observed countries

1) 2015 forecast – EU Commission Winter Forecast 2015 [6]

2) 2016 forecast – EU Commission Winter Forecast 2016 [7]

3) Preliminary assessment, EU Commission Autumn Economic Forecast 2016, growth forecast for FYR Macedonia corrected to a higher value because the records of the EU Commission deviate significantly from the records of the Macedonian Statistical Office.

Note: as BH is not a candidate country, EU Commission does not provide forecasts, so we have left it out of this analysis.

4) EU Commission forecast (Autumn Economic Forecast 2016) [8]

Table 2 shows that the countries in the region on average had a significantly larger GDP growth than forecasted – by 1.1. p.p. in 2015 and by 0.65 p.p. in 2016. To determine whether such deviations are unusual, we analyzed forecast errors for the previous period (2010-2014), for the same group of countries. Notable forecast errors in the observed period had occurred, but were random. GDP growth in the region was lower than expected in three out of five years prior to 2015, and in two years it was larger. The year 2013 is an interesting year for comparison with 2015 and 2016; in 2013, the growth also exceeded the forecast by about 1 p.p., just like in the last two years. However, a more detailed data analysis for 2013 reveals that large errors were made in growth forecasts only for the two largest economies in the region, Romania and Hungary. By excluding those two countries, the growth in the remaining economies in the region in 2013 would have been somewhat smaller than forecasted. This was not the case in 2015 and 2016, when the achieved growth was higher than forecasted even when the two largest economies were excluded. In addition, in 2013, there was no pattern in the growth of individual GDP components. GDP growth increase in Hungary, compared to forecasts, was the consequence of a growth in investments of over 11%, despite the fact that they were originally projected to be stagnant; in Romania, export deviated by almost 20% from the forecasts while the investment growth came in lower than it was expected.

Unlike 2013, forecast errors in 2015 and 2016 in the region were not only more widely distributed by countries, but also followed a certain pattern. Increase in private consumption in real terms, which surpassed the forecasts to a significant extent, was the common motor of the irregular GDP acceleration in the previous two years. Practically in all observed countries, in both years, private consumption was notably higher than forecasted, on average by about 1.7 p.p. per year (Table 3). Since private consumption contributes to the GDP with 60%, on average, in the countries in the region, this change had a critical impact on the growth of GDP beyond what was expected.

Table 3: Private consumption forecast errors in Serbia and in the surrounding countries, 2015-2016

Country	Forecasts 2015[1)]	Forecasts 2016[2)]	Growth 2015	Growth 2016[3)]	Forecasts errors 2015	Forecasts errors 2016
	%				p.p.	
Serbia	-1,8	0,5	0,5	1,2	+ 2.3	+ 0.7
Neighbouring countries (weighted average)	2,3	4,4	4,0	6,1	+ 1.7	+ 1.7
Albania	2,9	2,4	1,0	2,8	- 1.9	+ 0.4
Bulgaria	0,8	1,4	4,5	3,2	+ 3.7	+ 1.8
Croatia	0,0	1,8	1,2	2,7	+ 1.2	+ 0.9
Hungary	2,8	3,2	3,4	4,9	+ 0.6	+ 1.7
FYR Macedonia	2,3	2,4	3,2	2,4	+ 0.9	0.0
Montenegro	2,1	1,5	2,2	3,3	+ 0.1	+ 1.8
Romania	3,0	6,9	5,1	9,0	+ 2.1	+ 2.1

Source: EU Commission
1) 2015 forecast – EU Commission Winter Forecast 2015
2) 2016 forecast – EU Commission Winter Forecast 2016
3) EU Commission forecast (Autumn Economic Forecast 2016)

Tables 2 and 3 imply that the unplanned growth of real private consumption did not fully feed into the acceleration of GDP growth. However, this is completely expected. A larger consumption growth does not increase domestic output at the same rate, as a part of this increase is covered through higher imports. This is exactly what happened in the countries in the region in 2015 and 2016. Import growth, in real terms, in the region in the last two years was notably higher than expected, amounting to 6.7% in 2015 (compared to the 5.2% envisaged) and 7.4% in 2016 (compared to the forecast of 6.2%). Finally, an increased import in the countries in the region also drives a somewhat increased export, as these countries trade with each other. For example, if Romanian import shows an unusual increase, this encourages a somewhat greater export from Bulgaria, as Romania is one of Bulgaria's largest export markets. In 2015, export growth in the region, in real terms, was forecast at 5.4% and came in at 6.7%, whereas in 2016, it was forecast at 5.6% and came in at 5.9%. The remaining GDP components, public consumption and investments, did not significantly deviate from the original forecasts in the observed years.

Therefore, the analysis of forecast errors for individual GDP components shows that there is a common pattern of deviation during 2015 and 2016, in almost all countries in the region. The main reason for this error is the unexpected acceleration of real private consumption by about 1.7 p.p. relative to forecasts, for both years. This then reflected on an unexpected import increase and, to a somewhat lesser extent, greater export growth in the countries in the region, while the remaining GDP components showed no significant deviation from forecasts. This result is especially indicative when it is noted that the countries surrounding Serbia are extremely heterogeneous (diverse in size, development level, production structure, some are EU members, some are not). Presence of a common pattern, which shows that GDP components of very diverse countries deviated from the original prognosis indicates that common, external factors had a great impact on the increase in economic growth in the last two years, affecting all observed economies in a similar way.

Using this method, it is impossible to calculate precisely just how much of an influence the external factors have had on the acceleration of economic growth in the previous two years. Namely, some favourable circumstances at the international level were perhaps already known at the time GDP was forecasted, which would mean they had no bearing on the forecast error even though they perhaps did have an effect on GDP growth. At that, precise estimation is additionally complicated by the fact that certain external factors impacted GDP in 2015 on a one-off basis, while others were more permanent in nature etc. Still, when we assess the impact of the three GDP components that showed a systemic error in 2015 and 2016 forecasts (consumption – import + export), we can say with great certainty that the influence of external factors on economic growth acceleration in the region in the previous two years amounted to about 1 p.p. This, then, means that the observed economic growth acceleration in the region, from about 2.5% in 2013 and 2014 to about 3.5% in 2015 and 2016 (Table 1) came primarily from the impact of external factors – and not as a consequence of reforms implemented in the observed countries.

In Serbia, the situation is different only to a certain extent being that, all things considered, there are two simultaneous trends pushing the economic growth. A relatively successful implementation of fiscal consolidation, which brought about macroeconomic stability, with the reformed Labour Law, Law on Planning and Construction etc., probably contributed to Serbia catching up to the economic growth of the countries in the region, to a certain extent (Table 1). However, the growth in Serbia in 2015 and 2016 would most likely be about 1 p.p. lower, just like in the countries in the region, had it not been surprisingly accelerated by the favourable international factors.

At the end of this section, we shall discuss briefly about the most important external factor that affected the surprising economic growth acceleration in Serbia and the countries in the region in 2015 and 2016. Since the increase in private consumption, in real terms, has been identified as the strongest channel through which external factors have acted, it shows that the largest impact on economic growth acceleration in the region probably came from the global drop in the prices of commodities (oil, gas, food). This price drop had an effect on the increase in the disposable income among the population, which was able to consume more, in real terms, with the same income; i.e. there was an unplanned increase in consumption, in real terms. Table 4 shows the trends of average prices of oil and wheat in the last three years, as illustrations for the commodity price trends in 2015 and 2016. The same Table also presents the IMF's forecasts on future trends in the prices of these commodities at the time of GDP forecasting for the countries in the region.

Table 4: Average annual price of oil and wheat, forecast and realization, 2014-2016

Commodity	2014	Forecast 2015[1)]	Achieved 2015	Forecast 2016[2)]	Achieved 2016
			USD / barrel		
Oil (Brent)	99	80	52	50	44
			USD / MT		
Wheat	243	220	186	175	143

Source: IMF
1) IMF, Commodity Price Outlook & Risks, November 2014
2) IMF, Commodity Price Outlook & Risks, November 2015

In addition to this (apparently most important) channel that affected economic growth acceleration in the region in the previous two years, data analysis shows that during 2015, the region experienced a one-off positive effect of the somewhat accelerated growth in the Eurozone. GDP growth in the Eurozone amounted to 2% in 2015 which was faster than the average growth from the several preceding years (Table 1). Among the GDP components in the Eurozone, import growth stands out as it amounted to 6.4% in real terms. This import increase most likely induced the relatively high real export growth of the countries in the region in 2015, in the amount of 6.7%. The growth of export in the region, however, slowed down already in 2016 to 5.9%; this was probably also due to the effects of the decreased import of the Euro zone, in real terms, down to a mere 3%. The last exogenous factors that we believe had an impact on a somewhat faster economic growth in the region, especially in 2016, are low interest rates. For the time being, this is reflected in the increased borrowing among the population in the region, in 2016 (which also lead to a larger consumption growth, in real terms, than was expected); for the time being, corporate borrowing is not catching up with this trend. The last regional IMF report for Central, Eastern and South-Eastern Europe[1] from November analyzes the initiated recovery of loan activities in the CIE and forecasts further acceleration of this trend.

Perhaps with a few exceptions, external factors that contributed to a somewhat faster recovery of the region and Serbia in 2015 and 2016 will probably be exhausted quickly in the upcoming years. Oil and food prices have already started bouncing back, while interest rates in the USA are slowly rising (there are still no hints of that for the Euro zone). This is why further economic growth acceleration in Serbia will increasingly depend on its internal drivers. The problem, however, is that the structure of domestic production still fails to meet the requirements for

[1] IMF; Regional Economic Outlook; Central, Eastern and Southeastern Europe (CESEE): Effective Government for Stronger Growth; November 2016

a high and sustainable economic growth exceeding 4%. In the next section, we shall look in more detail at the analysis of the main internal obstacles that stand in the way of a high economic growth in Serbia.

2.2. Insufficient investments – the main obstacle to Serbian economic growth

In this section, we shall look at internal weaknesses of Serbian economy, which have prevented high GDP growth rates in the period since the end of the first wave of the world economic crisis. Namely, since 2010, economic growth in Serbia has been very low and lagged far behind the other countries of Central and Eastern Europe (including countries in the region). Average GDP growth in Serbia in the period 2010-2016 was about 0.5%, while, at the same time, the average economic growth in CEE countries amounted to 2.5% and of the countries in the region, about 2%. Of all the CEE countries, only Croatia recorded a lower economic growth than Serbia in the last seven years.

The main structural cause of the low economic growth in Serbia and the lag behind other CEE countries lies in the insufficient share of investments in the GDP, which has been present for years. For a high and sustainable economic growth in Serbia, the share of investments in the GDP should be about 25%, i.e. at least at the level of the regional average, which is 23% (Table 5). However, Serbian economy (including both the public and the private sector) has been investing, on average, only about 18% of the GDP since 2010. Insufficient investments are not only a direct obstacle to economic growth, but they contribute to macroeconomic imbalance as well. This can also be seen from Table 5, where we compared the GDP structure by consumption components in Serbia and in CEE and countries in the region. Table 5 shows that, in addition to the low share of investments, Serbian economy also deviates from the CEE average by a low share of export and a high share of private consumption. A strong increase in investments, especially investments into the production of tradable commodities, would not only directly lead to economic growth acceleration, but would also improve the overall GDP structure. In other words, the growth of investments would significantly accelerate the growth of export. Through a high and sustainable economic growth based on investments and export, Serbian economy would gradually increase their share in the GDP, lowering the excessive share of the private consumption.

Table 5: GDP structure by consumption in CEE and the countries in the region in 2015

% of GDP	Private consumption (C)	Public consumption (G)	Gross fixed capital formation (I)	Exports, goods and services (X)	Imports, goods and services (M)
Serbia	74,7	16,2	17,7	46,7	56,4
CEE (weighted average)	57,4	17,7	22,0	61,1	58,7
Neighbouring countries (weighted average)	59,9	16,4	22,7	57,2	56,8
Albania	80,0	10,9	27,2	27,2	44,5
Bosnia and Herzegovina	80,5	21,0	17,3	33,9	53,5
Bulgaria	62,5	16,1	21,0	64,1	64,0
Croatia	58,8	19,7	19,5	50,0	47,2
Hungary	49,3	20,0	21,7	90,7	81,8
FYR Macedonia	67,7	16,7	23,0	48,5	64,8
Montenegro	79,2	19,4	20,3	42,5	61,1
Romania	61,4	13,5	24,7	41,1	41,6

Source: European Commission, IMF, Office of Statistics of Bosnia and Herzegovina

Note: Data on GDP structure of the CEE countries by consumption for 2015 were taken from the EU Commission report (Autumn Economic Forecast 2016) for EU member states and candidate countries. For BH, the data were taken from the records of the Office of Statistics of Bosnia and Herzegovina. Weights by countries have been determined based on IMF's data on GDP (PPP) of the individual countries in 2015.

To analyze investments in Serbia, we have classified them into *public investments*; investments of the *public and state-owned enterprises* and investments of the *private sector.* The analysis shows that the government is implementing *public investments* both inefficiently and insufficiently; they would have to increase by at least 1% of GDP. In addition, poor management of *public and state-owned enterprises* has led to their investments falling short of the necessary level by at least 1% of GDP as well. Nevertheless, the largest gap in investments, of about 3% of GDP, pertains to the *private sector*. Within investments of the private sector, there are indications that the situation varies among the different enterprises. Investments of domestic, small and medium enterprises and

entrepreneurs, by all accounts, seem to be suffering the most, as they are the ones most affected by the poor business climate in Serbia. On the other hand, large domestic and foreign enterprises find it easier to invest and thus invest more. Economic policies favouring investment increase (and economic growth acceleration) therefore pertain to: 1) increase in the share of public investments in the GDP (by at least 1% of GDP) 2) improvement of the performance of public enterprises and resolution of the fate of state-owned enterprises (investment increase by at least 1% of GDP); and 3) improvement of the investment climate to foster private investment, primarily from small and medium enterprises (by about 3% of GDP).

2.2.1. Public investments

Public investments have a double significance for the achievement of a high and sustainable economic growth in Serbia. Namely, while they are being implemented, public investments have a positive impact on GDP and represent the public expenditures of the highest quality (greatest impact on GDP growth). However, public investments do not spur economic growth only in the short term, but also in the medium term, as they improve the quality of infrastructure in the country, which, at the moment, is not satisfactory. Even though public investment increase represents the best anti-recession state policy, in the previous years, Serbia held the infamous record with the lowest share of public investment in GDP in the entire CEE (Table 6).

Table 6: Share of public investment in GDP in Serbia, CEE and countries in the region, 2013-2015

% of GDP	2013	2014	2015	average 2013-2015
Serbia	2,2	2,5	2,8	2,5
CEE (weighted average)	4,1	4,5	5,0	4,5
Neighbouring countries (weighted average)	4,3	4,7	5,4	4,8
Albania	4,8	4,3	4,3	4,5
Bosnia and Herzegovina	5,0	5,3	3,5	4,6
Bulgaria	4,0	5,2	6,6	5,3
Croatia	3,7	3,6	3,2	3,5
Hungary	4,4	5,4	6,6	5,5
FYR Macedonia	3,3	3,3	3,3	3,3
Montenegro	3,9	5,5	8,1	5,8
Romania	4,5	4,3	5,1	4,6

Source: Eurostat, IMF, ministries of finance of individual countries

In 2016, there was an encouraging growth of public investments in Serbia, reaching 3.3% of GDP in that year. However, the average share of investments in GDP in CEE countries is about 4.5%, while in the countries in the region, that percentage is even higher, about 4.8% of GDP (Table 6). Therefore, the increase that occurred in Serbia in 2016 is still insufficient. Analysis of public investments in Serbia shows that the main reason for their poor implementation lies in the inefficiency of the administration, as other preconditions for public investment growth have been met: 1) there are indisputable investment priorities (construction of road and railway corridors, local infrastructure, i.e. water supply and sewers, clinical centres etc.); 2) the current state of infrastructure in Serbia has been rated as poor in all relevant research studies, so there is a great need for government investments; and 3) for a large number of projects, funding has been provided from international institutions under favourable conditions.

Therefore, Serbia should increase the share of public investments from the current level (in 2016) of 3.3% of GDP by about 1% of GDP in the upcoming years, to close the gap to the CEE average. Almost a half of this increase should come from large projects at the national level, which are mostly known and often mentioned in public (road corridors etc.). However, we would like to note that the other half of the public investment increase (of at least 0.5% of GDP) should be implemented at the local level, which the public does not get to hear about as often. Serbia is one of the rare European countries in which the local governments are still failing, in the second decade of the 21st century, to provide access to basic services to their population, in line with their competencies. Thus, for example, only 70% of the public water supply networks in Central Serbia comply with all quality requirements;

in Vojvodina, this percentage is as low as 16%. Only about 60% of the population is connected to the sewers, compared to the European average exceeding 80%. As an additional illustration of the impermissibly low quality of local infrastructure, a very low share of waste water in Serbia (only about 10-15% of the overall discharge) is treated, while almost the entire quantity of waste water in Europe undergoes treatment.[2]

2.2.2. Investments of public and state-owned enterprises

The second part of investments under direct government control, which are not being implemented to a satisfactory degree, pertain to investments of public and state-owned enterprises. Many years of poor management have led these enterprises to become indebted loss-makers, instead of using their profit and investments to drive economic growth. As a good illustration of the problem of insufficient investments from public and state-owned enterprises, we have presented data from financial reports of the largest public enterprise, EPS, pertaining to its investments and depreciation, in Table 7. The Table shows that EPS has not invested sufficiently for years, keeping its investments well below the depreciation. Not only is such a business model unsustainable for the enterprise itself, but it can act as a large impediment for economic growth in the upcoming years: with such low investments from EPS, Serbia will not have the energy capacity to support this growth.

Table 7: Investments and depreciation at EPS, 2013-2015.

(in mln rsd)	**2013**	**2014**	**2015**
Investments	17.556	24.210	25.184
Depreciation	37.354	38.775	39.592
Investment gap (depreciation - investments)	19.798	14.564	14.408

Source: EPS Financial reports 2013 – 2015.

Table 7 indicates that EPS alone should be investing 0.5% of GDP more than it currently does, to bring its investments above the level of depreciation, i.e. to increase production capacities instead of decreasing them. EPS, however, although it is the largest enterprise, is not the only public or state-owned enterprises with insufficient investments. The situation in large state-owned enterprises (*RTB Bor, Azotara, Petrohemija* etc) is especially alarming, as in some places, the lack of investments also represents an environmental hazard (rehabilitation of the mine tailings of RTB Bor, for example). We therefore estimate that there is a gap in investments in Serbia of at least 1% of GDP, as a consequence of poor business performance of public and state-owned enterprises. Thus, important leverage for investment increase and economic growth acceleration in Serbia encompasses: 1) reform of public enterprises; their problems have been known for a long time, but the resolution keeps getting delayed; and 2) resolution of the fate of failing state-owned enterprises that should be privatized or undergo bankruptcy. In this context, there is a problem with the Government's policy from the previous years, reflected in collection of large dividends from public enterprises into the budget (with the funds ending up, for the most part, in current expenditures) instead of encouraging these enterprises to increase their investments.

2.2.3. Private sector investments

By increasing public investments, reforming public enterprises and privatizing state-owned enterprises, the Government could directly affect the share of overall investments in Serbia, increasing it from the current level of 18% of GDP to 20-21% of GDP. This would be an important step in closing the gap to the desired level of investments in Serbia, which is 25% of the GDP; however, the largest share of the necessary increase would have to be implemented in the private sector. The role of the administration in encouraging private investment is indirect, but very important and pertains primarily to improvements in the business climate in Serbia, which has been rated very poorly by the relevant international institutions. The best rank Serbia holds, the 47th place, is on the Doing Business List of the World Bank, on which Serbia has climbed by 7 ranks in the last year. However, on

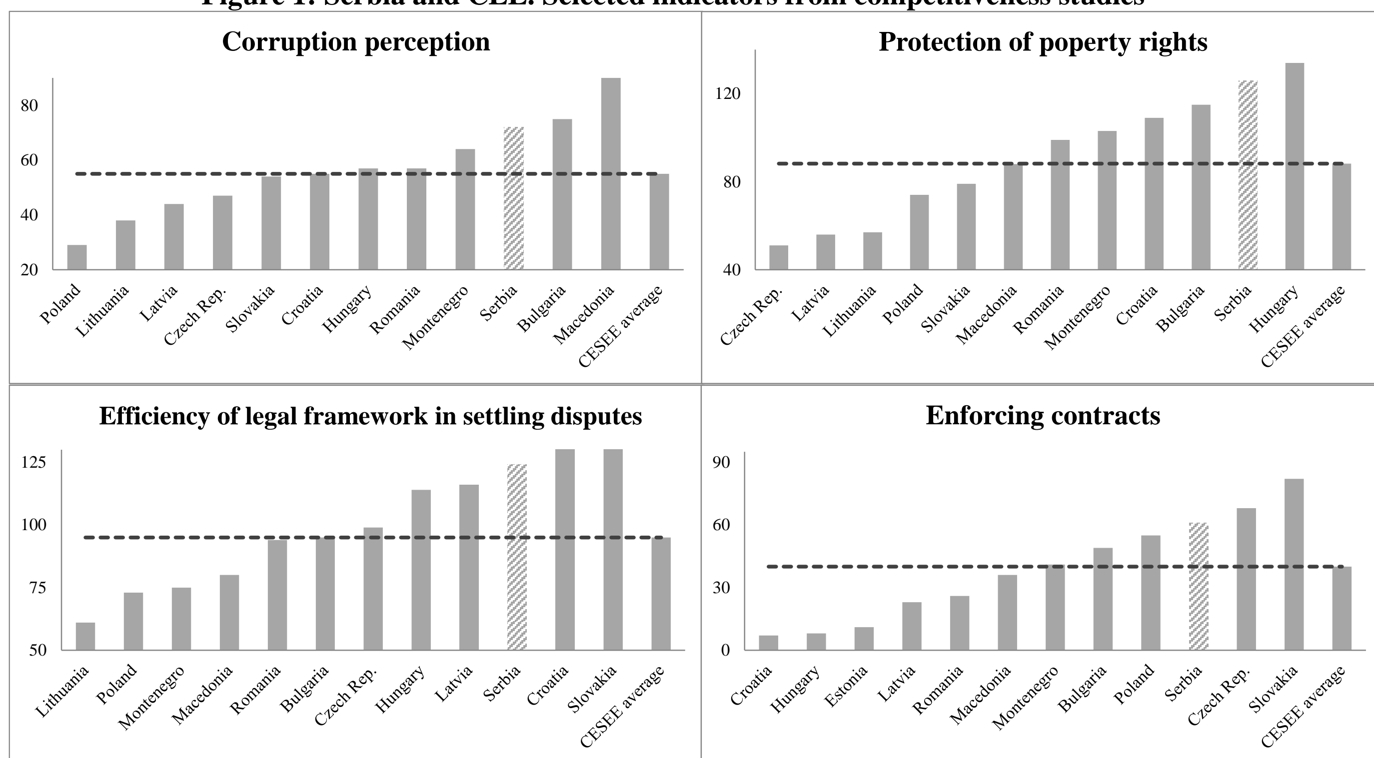
[2] Data from the Fiscal Council report "Fiscal trends in 2016, consolidation and reforms 2016-2020" from June 2016, based on the research on health and safety of the drinking water in public water supplies and water facilities in the Republic of Serbia in 2014, by the Institute of Public Health "Dr Milan Jovanović Batut" and the research of the SORS entitled "Waste water from settlements in the Republic of Serbia" from 2014.

the list of the World Economic Forum (WEF), which is more comprehensive than that of the World Bank, Serbia ranks at the very poor 90th position, with a modest improvement of 4 positions in the last year. Finally, according to the Index of Corruption Perception, measured by Transparency International, Serbia has been stagnating for several years at the quite low, 72nd position.

In all of the observed lists, Serbia ranks particularly poorly in institutional efficiency and the rule of law. In Figure 1, we have presented some of the characteristic indicators from all three relevant research studies pertaining to corporate legal protection, i.e. protection of their property rights, contract enforcement, court efficiency and corruption perception – where Serbia is among the lowest ranking CEE countries in all research studies.

Although Serbia holds a low 90th rank in the overall WEF competitiveness ranking list, on the Protection of property rights it ranks even worse, at 126th position, and in Efficiency of legal framework in settling disputes, at the 132nd position (Figure 1). The situation is similar when it comes to the Doing Business List and its Enforcing contracts[3] indicator, where Serbia is ranked far lower than its overall rank in the 47th position – it holds the 61st position. According to World Bank research, the time to resolve a dispute, counted from the moment the plaintiff files the lawsuit in court until payment amounts to 635 days in Serbia, which is 150 days longer than the average in the region according to World Bank classification (Europe and Central Asia). In addition, the costs of such procedures are almost double in Serbia; while the quality of court decisions is significantly lower than average in the corresponding region.

Figure 1: Serbia and CEE. Selected indicators from competitiveness studies



Source: Corruption perception – Transparency international 2016, Protection of property rights and Efficiency of legal framework in settling disputes – WEF The Global Competitiveness Report 2016–2017, Enforcing contracts – WB Doing business 2017

There are indications that the issues with poor business climate have the highest impact on low investments of domestic, small and medium enterprises and entrepreneurs (SMEEs), while foreign and large domestic enterprises

[3] The enforcing contracts indicator measures the time and cost for resolving a commercial dispute through a local first-instance court, and the quality of judicial processes index, evaluating whether each economy has adopted a series of good practices that promote quality and efficiency in the court system.

have an easier time finding ways to invest in Serbia. This is indirectly suggested by several different indicators. For example, SMEEs participate with a share of about two thirds in the number employees and in the turnover of the non-financial sector of Serbian economy – but their investments fall far short of that, i.e. over a half of the investments from the non-financial sector comes from the large enterprises.[4] An indicator that indirectly shows that foreign enterprises find it somewhat easier to invest in Serbia than the domestic enterprises is the net FDI in Serbia, which amounted to 5.4% of GDP in 2015, a little above the average of the countries in the region (only Montenegro and Albania have higher foreign direct investments relative to GDP). Although this topic warrants additional research, the indicators point to a logical conclusion – that the poor business environment has the largest negative impact on the investments of the domestic SMEEs, while large and foreign enterprises find it somehow easier to overcome the barriers to investments, even in poor investment climates.

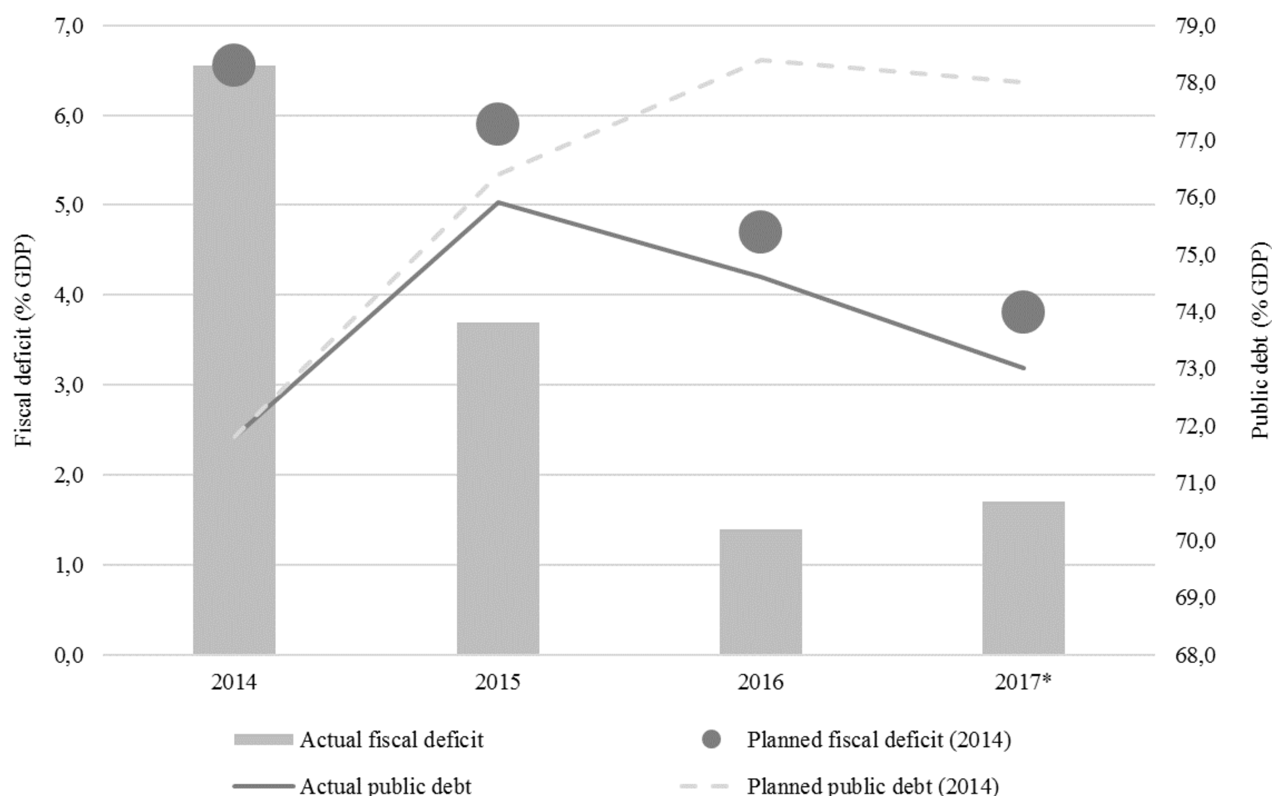
3. Fiscal consolidation 2015 – 2017: key findings

The end of 2014 marked the beginning of a three-year period of fiscal consolidation. Its objective was to reign in an uncontrolled public debt growth first and then to set Serbian public finances firmly on sustainable grounds. To meet the first objective, the Government planned to decrease the fiscal deficit from 6.6% of GDP in 2014 to 3.8% of GDP in 2017, which was supposed to stop the public debt growth at the level of about 78% of GDP. [14] Although we are only at the beginning of the third (and final) year that the initial plan pertains to, it is already clear that the core fiscal objectives have been fulfilled, and even surpassed. Namely, in the budget plan for 2017, forecast for the general government deficit is 1.7% of GDP this year (in our view, it is realistic) [15], which is about 750 Mln Euros less than originally planned. As fiscal deficits through the entire period 2015-2017 will be smaller than their initially targeted values (from 2014 plan), public debt trend will also be more favourable (see Figure 2). A mild shift in the growth of public debt occurred already in 2016, while the latest forecasts show that at the end of 2017, public debt will amount to about 73% of GDP. This means that at the end of the three-year fiscal consolidation programme, the national public debt will be smaller than initially forecasted by about 5 p.p. of GDP, or 1.8 Bln Euros.

In the first part of this chapter, we analyzed the surprisingly good fiscal results and showed that they are founded, for the large part, on the strong unforeseen increase in public revenue, rather than on the expenditure austerity measures from the initial fiscal consolidation plan for 2015-2017. In the second part of the chapter, we focused on the issues of sustainability of the achieved results and showed that approximately a half of the permanent fiscal deficit decrease would still hang in the balance – if it not supported by the appropriate structural reforms. Finally, we showed that due to unsatisfactory results in the implementation of the reform segment of the programme (primarily the reforms in public and state-owned enterprises), Serbian public finance is still under threat from the same fiscal risks that could practically annul all the results achieved so far. Taking all this into consideration, as well as the fact that a public debt of 75% of GDP is still too high for a country like Serbia, a somewhat more restrictive fiscal policy accompanied by a far more decisive implementation of structural reforms in the years to come has no true alternative.

[4] Source: Ministry of Economy, 2015, "Report on small and medium enterprises and entrepreneurs for 2014"

Figure 2: Republic of Serbia: Planned and actual fiscal deficit and public debt, 2014-2017



Source: Ministry of Finance
Note: Data on the real deficit and public debt in 2017 are actually the latest official forecasts for this year and have been taken from the Fiscal Strategy for 2017 with forecasts for 2018 and 2019.

3.1. Why have fiscal results exceeded expectations?

The initial fiscal consolidation plan from the end of 2014 envisaged austerity measures primarily aimed at the decrease of the unsustainably high public expenditures – according to the three-year plan of the Government, by 1.7 Bln Euros (over 5% of the GDP).[5] These austerity measures were designed to address the largest sources of fiscal imbalance – excessive wage and pension bill, as well as very generous subsidies compared to similar countries, relative to the economic power of the national economy. As early as at the end of 2014, there was a linear cut of public sector salaries exceeding 25,000 dinars by 10% and a progressive pension cut (approximately equivalent to a linear cut in the amount of about 5%). Additional savings on the largest items in budget expenditures were supposed to come from a salary freeze in the period 2015-2017 (i.e. a decrease in real terms) and from a very ambitious plan of general government downsizing by about 5% annually (in total, encompassing about 75,000 employees). The remaining permanent fiscal deficit decrease was supposed to be ensured by several smaller measures, such as a subsidy cut for agriculture and public media services (companies *RTS* and *RTV*) and an introduction of excise on electricity and a gas transit fee. While the aforementioned austerity measures were expected to mitigate the existing structural imbalance between public expenditure and public revenue, the second pillar of fiscal consolidation (reform of public and completion of privatization of state-owned enterprises) was

[5] To achieve the planned permanent fiscal deficit decrease by about 3 p.p. of GDP, it was necessary to ensure savings in public expenditures exceeding 5% of GDP. Namely, in the 2015-2017 period, increases were expected in interest expenditures (of about 1 p.p. of GDP), public investment expenditures (by about 0.5 p.p. of GDP) as well as a decrease in VAT revenue by 0.7 p.p. of GDP due to rebalancing of the economy (consumption cuts combined with increased investments and export).

supposed to ensure the sustainability of such savings. Bad performance of state-owned enterprises and the spill-over of their enormous losses to the public finance was recognized as the largest fiscal risk, by far, exactly because this had been the reason behind the failure of the first fiscal consolidation attempt in the period 2012-2014. [13]

Although the set objectives were in principle adequate, at the end of 2014 the Fiscal Council assessed that the initial plan of fiscal consolidation for 2015-2017 lacked plausibility, as some of the austerity measures were not well designed.[6] This assessment pertained in particular to the planned cut of the wage bill of almost 30% in real terms in only three years, which was assessed not only as difficult, but also as economically questionable. For example, this would transform Serbia, in a very short time period, from a country spending about 2 p.p. of the GDP more than the comparable countries on these purposes, to a country spending 1 p.p. of GDP less than the CEE average. However, it was completely unrealistic to expect that the number of general government employees would be decreased by 15% in a three-year period without prior sectoral analyses, which would identify precisely where these superfluous employees were. The plan for the real decrease in salaries and pensions based on their freeze until 2017 was not too plausible either – after they had already been cut in November 2014. One of the austerity measures envisaged that, starting from 2015, the budget would no longer cover the losses of state-owned enterprises by issuing new guarantees; it too was not supported by adequate reforms in the largest public (Srbijagas, EPS, Železnice Srbije) and state-owned (RTB Bor, Petrohemija, Azotara, MSK etc.) enterprises. Without a clear reform plan, it was just a matter of time when the need for state aid, in the form of direct or indirect subsidies to one of the loss-making enterprises, would arise again.

Analysis of the fiscal plans for 2017 reveals that only slightly over a half of the originally planned savings have been accomplished. As can be seen from Table 8, public expenditure decrease, relative to GDP, was smaller than planned, so in the last year of programme implementation, public expenditures are expected to exceed the initial plan by about 650 Mln Euros. The largest savings were achieved on the wage and pension bill, primarily due to the salary and pension cut from November 2014; in addition, the parametric pension reform[7] from 2014 also brought somewhat larger savings than had been planned. However, the remaining austerity measures, aimed at decreasing the largest budget expenditures, have failed to yield the desired results. According to the latest data, the number of general government employees has been decreased by a mere 17,000 (the downsizing planned for this year calls for an additional 5,000), meaning that not even a third of the originally planned savings is likely to be achieved. In addition, a decrease in salaries and pensions planned for the period of 2015-2017, in real terms, practically has not happened at all, as the inflation was significantly lower than forecasted, but also because the decision on the salary and pension freeze has already been suspended twice.[8] Consequently, the expected wage and pension bill in 2017 is 450-500 Mln Euros larger than planned at the end of 2014. Significant savings have been achieved through a decrease in subsidies for agriculture and public media services, even though these measures were implemented with a certain delay. Introduction of a gas transit fee was expected to yield 60 Mln Euros in annual revenue for Srbijagas (which was the amount by which budget expenditures for the activation of guarantees for this public enterprise were to be decreased); however, the revenue collected on these grounds fell short of a half of the planned amount.

Taking into consideration all the missed opportunities for savings, fiscal consolidation 2015-2017 would surely have failed had it rested exclusively on the austerity measures from the 2014 plan. However, this was not the case. Public revenue collection was a very positive surprise, so the fiscal deficit in 2017 will actually be significantly lower than planned at the beginning of the fiscal consolidation – 1.7% of GDP instead of 3.8% of GDP. As was

[6] An additional objection of the Fiscal Council was that the planned fiscal deficit decrease to 3.8% of GDP was, in principle, insufficient to stop the growth of public debt, without an optimistic assumption of a relatively strong appreciation of the dinar.

[7] All things considered, a gradual increase of the age of retirement for women (from 63 to 65) and an introduction of actuarial penalties for premature retirement seems to have slowed down the increase in the number of pensioners (and pension expenses) more than it had been expected.

[8] In 2016, salaries were increased, by 2.5% on average (including the parts of general government where there was no increase), pensions were increased by 1.25%, while in 2017, these increases were even somewhat larger: salaries increased, by about 4% on average and pensions by about 1.5%.

shown in Table 8, total public revenue in 2017 is expected to exceed the initial plan by about 4 p.p. of GDP (1.4 Bln Euros), which is more than sufficient to make up for the missed savings on public expenditures, of about 650 Mln Euros. A more detailed analysis shows there are three basic sources of public revenue increase beyond the original expectations: a strong growth in one-off non-tax revenue, partly as a result of decisions at the discretion of the Government, more favourable macroeconomic trends and a visible increase in the tax revenue collection efficiency.

In 2017, non-tax revenue will exceed the level envisaged in the initial fiscal consolidation plan by about 0.6 p.p. of GDP or about 200 Mln Euros. This will continue the trend of surprisingly large non-tax revenue, established in the previous two years, as the plan for 2015 was exceeded by 1 p.p. of GDP, and in 2016, by as much as 1.6 p.p. of GDP. Unusually high revenues coming from the profit of public and state-owned enterprises (including local public enterprises) and other one-off payments into the budget contributed significantly to a greater decrease in the fiscal deficit in 2015 and 2016 than originally planned.[9] Seeing as how there are no significant one-off payments planned for 2017 on other grounds, the 200 Mln Euro increase in non-tax revenue, compared to the original plan, rests predominantly on a greater withdrawal of liquid assets from public and state-owned enterprises. Taking into account the performance reported by some enterprises, the planned amount of non-tax revenue may be achievable, but its economic justification is questionable. Namely, the largest payments are expected to come from *EPS* and *Telekom* – two large enterprises owned by the state, which have been underinvesting for years (with *EPS* heavily indebted, as well). EPS's investments are often insufficient to cover depreciation, slowly diminishing the energy capacities, which can be a significant obstacle to acceleration of economic growth in medium and long term. Telekom's problems are perhaps not as obvious, but this state-owned enterprise is facing sharp competition in the telecommunication market and is continually losing its market share. With all this in mind, the short-term benefit that the general government is to achieve from the unusually high payments, coming from the profit of these enterprises, could be smaller than the damage that could arise if these enterprises are excessively financially drained.

[9] The revenue from the 4G network license sale (about 13 Bln dinars), repayment of old EPS's debt to the central government through the Agency for Deposit Security (in total, exceeding 10 Bln dinars) and revenue from the sale of construction land in Novi Sad (4 Bln dinars) are only a few of the larger one-off payments into the budget in the previous two years.

Table 8: Fiscal consolidation 2015-2017: initial plan vs execution

in % of GDP	IMF Program Scenario 2014	2015	2016	2017	Execution 2014-2016 2014	2015	2016	Plan* 2017
Revenue	40.9	40.3	39.2	38.5	41.5	41.9	43.8	42.4
Taxes	36.6	35.6	34.7	34.1	36.8	36.2	37.7	37.3
Personal income tax	3.7	3.6	3.4	3.4	3.7	3.6	3.7	3.7
Social security contributions	12.9	12.2	11.7	11.5	13.0	12.5	12.5	12.6
Taxes on profits	1.9	1.9	1.9	1.9	1.9	1.5	1.9	1.8
Value-added taxes	10.4	10.1	9.8	9.6	10.5	10.3	10.8	10.6
Excises	5.5	5.7	5.8	5.6	5.4	5.8	6.3	6.2
Taxes on international trade	0.8	0.7	0.7	0.7	0.8	0.8	0.9	0.9
Other taxes	1.4	1.4	1.4	1.4	1.5	1.6	1.6	1.5
Non-tax revenue	4.1	4.5	4.3	4.2	4.4	5.5	5.9	4.8
Grants	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.3
Expenditure	48.4	46.2	43.9	42.3	48.1	45.6	45.2	44.1
Current expenditure	44.7	42.2	40	38.7	43.4	42.0	40.9	39.9
Wages and salaries[1]	11.8	10.7	9.7	8.9	11.7	10.4	9.9	9.9
W&S without severance payments	*11.8*	*10.4*	*9.3*	*8.5*	*11.7*	*10.4*	*9.8*	*9.8*
Goods and services	7.8	7.6	7.4	7.4	7.9	7.5	8.1	8
Interest	3	3.5	3.9	4	2.9	3.2	3.1	3.1
Subsidies	4	2.6	2.3	2.4	3.0	3.3	2.7	2.4
Transfers	18.1	17.8	16.7	16	17.8	17.6	17.1	16.5
of which: Pensions[2]	13.1	12.4	11.8	11.3	13.0	12.1	11.8	11.6
Other transfers[3]	5	5.4	4.8	4.7	4.8	5.4	5.3	4.9
Capital expenditure	2.6	3.1	3.1	3	2.5	2.8	3.3	3.3
Net lending	0.3	0.1	0.1	0.1	1.4	0.1	0.1	0.1
Amortization of activated guarantees	0.8	0.8	0.7	0.5	0.8	0.7	0.9	0.8
Fiscal balance	-7.5	-5.9	-4.7	-3.8	-6.6	-3.7	-1.4	-1.7
Real GDP growth	-2	-0.5	1.5	2	-1.8	0.8	2.7	3
GDP nominal (billions of RSD)	3881	3967	4191	4450	3908	4043	4203	4397
Average consumer price (%)	2.1	2.7	4	4	2.1	1.4	1.2	2.4
Gross debt (% of GDP)	69.9	76.4	78.4	78	71.9	76	74.5	72.9

* Plan, Sixth review under the IMF stand-by arrangement (December 2016).
[1] Including contributions paid by employer, also including severance payments.
[2] Excluding one-off payments for pensioners in December 2016 (which are included in Other transfers).
[3] Including Transition fund, also military pension arrears in 2016.

A more favourable macroeconomic environment than forecasted at the end of 2014, especially the more favourable labour market trends, will lead to an increase in public revenue in the amount of 400-500 Mln Euros compared to the initial plan. Employment and average wage trends have significantly exceeded expectations on which the fiscal consolidation programme was drafted, leading to very positive trends in collection of revenue from social contributions and income taxes. In total these tax revenues were planned to come to about 16.3% of GDP in 2017, meaning that the initial plan will probably be exceeded by about 1.5 p.p. of GDP. It is indisputable that in part, this improvement comes as a result of a stronger recovery of the private sector, but it is important to emphasize that an inconsistent implementation of some of the fiscal consolidation measures has contributed, to a certain

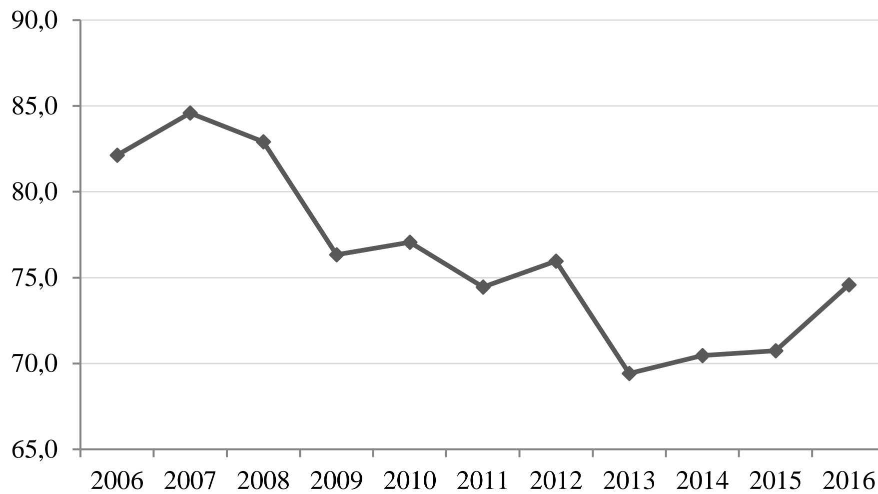
extent, to the larger collection of this type of revenue. First of all, the total number of employees in economy has not been decreased to the planned extent due to the fact that the general government downsizing has fallen short of its aim and because of the delay in reforms of the public enterprises and the resolution of the fate of enterprises undergoing privatization. In addition, selective salary increase in the public sector in 2016 and 2017 had an impact, albeit a modest one, on the increase of average salaries in the entire economy compared to the original plan, which was based on the assumption that the salaries would remain frozen for three years. Bearing all this in mind, it could be said that a part of the unaccomplished fiscal adjustment of public expenditures has been compensated by the consequentially larger social contribution revenue and income tax revenue.

Still, it was the more efficient tax revenue collection that probably contributed the most to the increase in public revenue compared to the initial plan (700-800 Mln Euros), which can primarily be seen in VAT and excise revenue. Furthermore, in VAT revenue, almost the entire overperformance compared to the original plan comes from improved collection (in excise revenue, the increase is partially due to favourable macroeconomic trends and subsequent amendments in the legislation). Namely, even though the domestic consumption in the period 2015-2017, in real terms, was truly a positive surprise, the inflation was significantly lower than expected – meaning that the tax base (nominal domestic consumption) did not fundamentally deviate from the original forecasts. In Figure 3, we have shown the trend of the coefficient of relative collection efficiency (c-efficiency), which is obtained by correlating the actual amount of revenue collected from VAT with a hypothetical amount that would have been collected assuming perfect collection. This indicator firmly corroborates the previous conclusion, that after a sharp dive in VAT collection efficiency in 2013, over the last several years there has been a trend of improved collection efficiency, which was most pronounced in 2016.[10] There are quite clear indications that these additional tax revenues has been collected through *ad hoc* measures that the Tax Administration implemented in the field, without having its capacities strengthened or its organisational structure modified. However, since a "normal" VAT collection rate from the period 2009-2012 has almost been matched in 2016, it is likely that the positive effect of these grey economy suppression measures has been exhausted for the most part.

A slower growth of interest expenditure is another contributor to the expectation-exceeding fiscal result, as in 2017 this category of expenditure will be by about 300 Mln Euros (0.9 p.p. of GDP) lower than originally planned. Being that one of the determinants of interest expenditure is the level of public debt, one part of the achieved savings (slightly under 0.2 p.p. of GDP) can be explained by the fact that the public debt will be smaller than expected at the end of 2017 (about 73% of GDP instead of 78% of GDP). However, the majority of savings on interest expenditure (over 0.7 p.p. of GDP) come from significantly more favourable lending conditions in the period 2015-2017, compared to expectations. The initial fiscal consolidation plan from the end of 2014 envisaged a gradual increase in implicit average interest rate on Serbian public debt from 4.2% at the time to 5.1% in 2017, but this did not occur – the implicit average interest rate remained at the level of about 4.2%. Even though this was probably somewhat supported by the decrease in country risk premiums, due to a successful beginning of fiscal consolidation and signing of the arrangement with the IMF, the main reason certainly lies in the global interest rate decrease. Due to interest rates that are at a historical low in the developed countries, investors looking for greater returns increased their demand for securities of developing countries, significantly lowering the price of lending for all countries in the region, including Serbia. It remains to be seen, however, how long such favourable lending conditions will last. It is expected that the American FED will accelerate the increase of the reference interest rate in 2017, which will certainly influence the interest rates in the rest of the world.

[10] The final data on the domestic consumption in 2016 is still not available, which is why this assessment is only preliminary. However, large and unexpected changes in the domestic consumption trends in the final quarter of 2016 that would have a quantitative impact on this conclusion are highly unlikely.

Figure 3: Collection efficiency of VAT (C-efficiency)

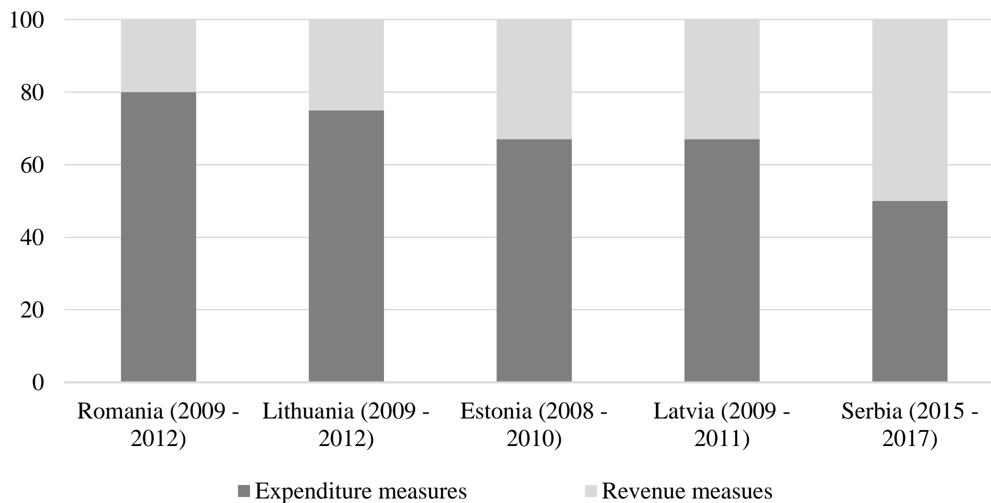


Source: Author's calculations.

3.2. How sustainable are the achieved results?

Realization of the quantitative objectives of 2015-2017 fiscal consolidation (decrease of the fiscal deficit and arrest of the public debt growth) was more than successful, but it was achieved in a manner that is far different than originally planned. The issue of fiscal adjustment quality often takes the back seat, but the structure of the achieved savings is very important for the sustainability of the achieved results and a lasting recovery of public finance. Namely, empirical research strongly suggests that fiscal consolidations founded mostly on austerity measures on the expenditure side (preserving the level of expenditures for public investments) have several important advantages compared to fiscal consolidations based on revenue measures: they are more plausible, their results are more permanent and if they are supported by structural reforms, they have a more favourable impact on economic growth in medium and long term. [1] [2] We analyzed experiences of four Central and Eastern European countries (Romania, Lithuania, Estonia and Latvia) which, in the period following the outbreak of the economic crisis in 2008, were successful in implementing very ambitious fiscal consolidations. Without exception, the permanent fiscal deficit decrease was achieved thanks to savings on public expenditures, which account for between 2/3 and 4/5 of the fiscal adjustment (see Figure 4).

Figure 4: Fiscal adjustment: expenditure vs. revenue measures (in percent of total)



Source: Author's calculations.

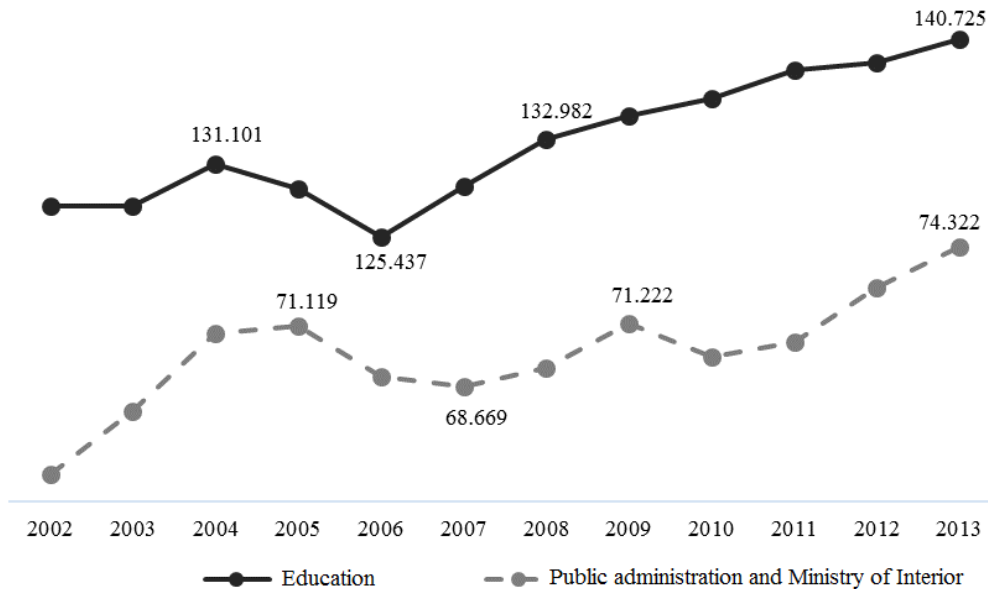
Although the Serbian fiscal consolidation of 2015-2017 was initially envisaged to achieve the largest part of the permanent fiscal deficit decrease through austerity measures on the expenditure side, the success was lukewarm.[11] Contrary to the original intentions, almost 50% of the fiscal deficit decrease was achieved thanks to an unplanned growth in public revenue. The final result is a public revenue and expenditure structure in 2017 that deviates significantly from that which was originally planned and would be optimal, which casts a shadow over the achieved fiscal adjustment. Namely, some of the basic imbalances in the budget remain: although decreased, wage and pension bill still exceed the sustainable level, subsidies will be larger by about 1 p.p. of GDP than in comparable countries, while public investments are insufficient and should be increased by at least 1 p.p. of GDP. It's good that the strong growth of interest expenditures has been stopped, but that too could prove to be a temporary success if there is a significant deterioration in lending terms for countries like Serbia in the years to come. Another consequence of an altered fiscal adjustment structure is that the level of public expenditure of about 45% of GDP is pretty high compared to the strength of Serbian economy. However, a much larger problem at the moment is that the fiscal deficit decrease achieved through better tax revenue collection and some non-systemic savings on public expenditures may not be maintained, if it is not supported by the necessary structural reform.

As we already mentioned, improvement in tax revenue collection in the previous two years mostly relied on grey economy suppression using well-targeted *ad hoc* measures that the Tax Administration implemented in the field. This is a commendable result, bearing in mind the inadequacies of tax administration capacities: average age of employees is over 50, salaries are not competitive compared to the private sector, analytical capacities are weak, organisational structure and information system are outdated etc. [9] It is especially alarming that there are only about 500 tax inspectors, while international experiences indicate that a country like Serbia should have at least 1,000 adequately qualified tax inspectors.[12] Hence, we believe that there is a pronounced risk that the current tax revenue collection level will not be maintained without the modernization of the Tax Administration, which would put all achieved results of the fiscal consolidation in serious jeopardy. A good plan for thorough Tax Administration reform for the period 2015-2020 has been in existence for several years, but its implementation is very slow. We also emphasize that a successful modernization of the Tax Administration is not only necessary to secure the results achieved in tax revenue collection, but also to ensure additional revenue from grey economy suppression in the upcoming years. Being that not all objectives of fiscal consolidation have been achieved according to plan, this could be of crucial importance for the continuation of the fiscal consolidation and a lasting recovery of Serbian public finance.

Even though general government downsizing was unsuccessful, certain savings (0.2-0.3% of GDP) have nevertheless been achieved, due to natural outflow of the retiring employees with a very restrictive replacement rate (5:1). Being that the targeted lay-offs based on precise analyses that identify superfluous employees have not taken place, these savings were not in essence systematic and are most probably unsustainable – as both productive and non-productive employees are retiring. In the long run, too strong a reliance on the natural outflow through retirement and on the new employment ban represents a serious hazard for the functioning of some important systems (e.g. education or healthcare sectors), as it could lead to a drop in the quality of service they provide. [5] Moreover, previous attempts to decrease the number of general government employees have shown that the effects were, most often, only short-lived. To illustrate this, the previous arrangements between Serbia and the IMF also lead to a linear downsizing (2002-2006 and 2009-2010). However, soon after the Arrangement ended, statistics show that the number of general government employees bounced back to the previous level, or even exceeded it (see Figure 5). To prevent similar situations from repeating in the following years, it is necessary to initiate a reform of the largest public systems, primarily healthcare and education, as soon as possible. One of the outcomes of these reforms would be a clearly defined number and structure of the employees needed, which would prevent an excessive and unjustified increase of employment once the employment ban has been lifted (most likely at the end of 2017).

[11] After the increase of general VAT rate from 18% to 20% and the lower VAT rate from 8% to 10%, as well as the profit tax from 10% to 15% in the period from 2012-2014, it was estimated that there was no more room for new tax rate increases.
[12] Moreover, Serbia has the fewest tax inspectors per capita compared to the countries in the region.

Figure 5: Number of employees in education, state administration and Ministry of Interior, 2002-2013



Source: National Office for Statistics

Fiscal risks are threatening to annul all that has been accomplished thus far, as other reform goals have not been met as well. This is especially true for the reform of public enterprises and the completion of privatization of state-owned enterprises as it is seriously overdue, even though it was one of the main objectives of the initiated fiscal consolidation. *Serbian Railways* are practically the only public enterprise in which necessary measures have been undertaken: the enterprise has been divided into four independent companies, a new manner of subsidizing increases efficiency, a large downsizing has been planned etc. There are certain problems and delays in the implementation of the planned reform measures, but despite this, *Serbian Railways* are the public enterprise that has went the furthest in the restructuring process. On the other hand, essential reforms of the *EPS* have been delayed for years, even though the enormous debt of this enterprise (in excess of 1 Bln Euros), which could fall to the budget, represents the largest fiscal risk. *Srbijagas's* performance depends directly on the resolution of problems in enterprises that are failing to pay for the delivered gas (petrochemical companies *Petrohemija, Azotara, MSK* and others), which has not yet occurred, so these companies continue to accumulate debt. Therefore, it is probably a matter of time before Srbijagas runs into liquidity problems again, which will require the issue of new guarantees for loans – regardless of the fact that the government has explicitly undertaken not to do that anymore. Finally, after the first and encouraging wave of resolving the status of enterprises undergoing privatization in 2015, it seems that the process has ground to a halt in 2016 (with the exception of the sale of the steel mill *Železara Smederevo* to the Chinese company *Hesteel*). There are no sustainable solutions on the horizon for the remaining enterprises from this group (copper mine *RTB Bor*, pharmaceutical company *Galenika*, agricultural corporation *PKB*, coal mine *Resavica*, furniture company *Simpo* and others), so the fiscal risk from their poor business performances keeps increasing.

Bad performance of public and state-owned enterprises already represents too great a burden on public finance, and since the hot-spots have not been addressed, new expenditures to cover their losses are almost inevitable. Namely, analysis of the Budget of the Republic of Serbia for 2017 reveals that the repayment of old debt of public and state-owned enterprises (made prior to 2015) comprises the largest part of the planned fiscal deficit in this year. In the overall total, these expenditures have reached the amount of 40 Bln dinars or 0.9% of GDP, while the total fiscal deficit is planned at 75 Bln dinars (1.7% of GDP). Without competition, the largest part of these expenditures comes from activated guarantees of Srbijagas (about 200 Mln Euros), together with Železnice Srbije (35 Mln Euros), Air Serbia (10 Mln Euros), Galenika (10 Mln Euros), Železara Smederevo (5 Mln Euros), subsidy

for RTB Bor (2 Bln dinars). What is problematic is that the well-known mechanisms that generate these expenditures are repeating in 2016: state-owned enterprises, local public enterprises and local governments have accumulated arrears, to Srbijagas and EPS of around 160 m Euros in that year alone. We emphasize that this is a problem in the making, which threatens to increase public expenditures in the future – whether through the issuance of a new guarantee to Srbijagas, to be repaid by the government, or through financial exhaustion of the EPS, the debts of which can also be transferred to the budget (despite the fact they were not covered by guarantees).

Finally, almost every year there are unplanned one-off expenditures that increase the fiscal deficit, which, as it seems now, will continue in the years to come. The main source of these expenditures also lies in the poor performance of public and state-owned enterprises, but it is not the only source. Thus, in 2016 the government took over the payment of Petrohemija to NIS (about 100 Mln Euros); in 2015 it was the debt of Srbijagas, also to NIS (about 200 Mln Euros) as well as army pensions arrears, in line with the decision of the Constitutional court (about 75 Mln Euros); in 2014, it was JAT's debt (about 170 Mln Euros) etc. Although it is hard to forecast the magnitude of these expenditures and the exact time they accrue, it is already possible to identify a few obligations that may fall to the budget in the future. For example, it is well known that RTB Bor's debt to NIS amounts to over 40 m Euros, whereas Galenika has an unguaranteed debt to banks in the amount of about 70 Mln Euros – which, just as is the case with some other enterprises, can be taken over as public debt at any time. We would also like to point out the problem of healthcare institutions accumulating arrears (hospital, health centres, pharmacy etc.), which have grown to almost 12 Bln dinars by February 2017 (the annual increase amounts to 2-3 Bln dinars). Payment of the accumulated arrears in healthcare has already fallen to the budget, when in 2013 obligations in the amount of about 5 Bln dinars were taken over, so it would not be a great surprise if it was to happen again. There is a similar problem in some local governments, and it is estimated that the arrears of the local administrations surpass 10 Bln dinars. A special risk comes from potential expenses grounded in disputes that the state is losing in international courts. For example, the International Court of Human Rights in Strasbourg has, in deliberating on the lawsuit filed by those with savings in Invest banka in Bosnia and Herzegovina, decided that Serbia is obliged to pay out the old foreign currency savings, in the amount estimated to about 200-300 Mln Euros.

When it is all summed up, the fiscal consolidation of 2015-2017 successfully resolved some acute issues in Serbian public finance – a high deficit of 2014 was decreased more than was originally planned, while the strong growth of public debt was stopped a year earlier than expected. Although it is an undisputedly good result, the general condition of public finance is still far from good – which is why it is dangerous that the general, and a part of the professional audience, form an opinion that the fiscal consolidation has practically been completed. Namely, with the public debt reaching about 75% of GDP, Serbia is still a highly indebted country – a single external "shock" would be sufficient to bring it back to the brink of a public debt crisis. This is why it will still be necessary, in the upcoming years, to implement a somewhat more restrictive fiscal policy and to permanently decrease the fiscal deficit down to 0.5% of GDP. Even with such a small fiscal deficit, it would take almost an entire decade to bring the public debt down to about 50% of GDP, which is the level of debt that would allow Serbia to await the next crisis relatively prepared – and this next crisis will surely happen in the long run. Our analysis of the fiscal consolidation 2015-2017 shows that this is possible in an economically desirable manner. It would be necessary to keep decreasing total public expenditures and achieve a fiscal balance at a level lower than the present 44-45% of GDP, with fine-tuning the structure of public spending (increase in public investments combined with a decrease in e.g. subsidies). Thus, together with a Tax Administration reform that would allow additional improvements in public revenue collection, some room would be opened for incentives to economic growth through a moderate reduction of the tax burden on the economy. However, none of it will be possible unless the resolution of accumulated problems in the unreformed public sector (primarily in public and state-owned enterprises) is accelerated, as expenditures that could fall to the budget could quite easily neutralize the results achieved so far.

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