



Republic of Serbia  
Fiscal Council

**ASSESSMENT OF THE DRAFT LAW AMENDING THE LAW ON THE  
REPUBLIC OF SERBIA 2011 BUDGET**

Belgrade, 29 September 2011

## Table of Contents

**Introductory Remarks** .....Error! Bookmark not defined.

**Basic assessments**.....Error! Bookmark not defined.

### **ASSESSMENT OF THE DRAFT LAW AMENDING THE LAW ON THE REPUBLIC OF SERBIA 2011 BUDGET**

<b>1. ECONOMIC ACTIVITY AND BUDGET DEFICIT</b> .....	<b>8</b>
1.1. Assessment of economic activity developments.....	8
1.2. Economic activity and fiscal rules.....	11
<b>2. FISCAL TRENDS IN THE FIRST SEVEN MONTHS OF 2011</b> .....	<b>12</b>
2.1. Public expenditures trend in the period January-July 2011 .....	12
2.2. Public expenditures deviation from planned 2011 budget framework.....	14
2.3. Public revenues trend in the period January-July 2011.....	16
2.4. Trend of general government and republican budget deficits.....	19
<b>3. ASSESSMENT OF NEW BUDGET PLAN FOR GENERAL GOVERNMENT IN 2011</b> .....	<b>20</b>
3.1. Analysis of agreed framework for general government’s public expenditures.....	20
3.2. Analysis of assessed public revenues trend in 2011 from the Memorandum of Economic and Financial Policies .....	22
3.3. Analysis of the Fiscal Policy by end of 2011 per different government levels .....	25
<b>4. PUBLIC DEBT IN 2011</b> .....	<b>27</b>
<b>5. REPUBLIC BUDGET REVISION</b> .....	<b>28</b>
5.1. General budget revision assessment.....	28
5.2. Basic implementation risks and economic justification of the most significant measures envisaged by the revision .....	30

## **Introductory Remarks**

The Fiscal Council is an independent Government agency, accountable to the National Assembly of the Republic of Serbia. According to Article 92ž of the Law on Budget System, a task of the Fiscal Council is to prepare and to submit to the National Assembly an analysis of the draft of the Republic of Serbia budget revision.

According to Article 92ž of the Budget System Law, the Fiscal Council is to submit an analysis of the draft balance revision within 15 days from the date under which the Government has submitted the budget revision to the National Assembly.

In conformance with the legal obligation, the Fiscal Council analyzed the Draft Law Amending the Law on the Republic of Serbia 2011 Budget and, according to the requirement set forth in Article 92ž of the Budget System Law the Fiscal Council is submitting to the National Assembly the assessment of the draft budget revision.

## BASIC ASSESSMENTS

**The republican budget is the largest single portion of the financial system of the general government and the basic lever for conducting the fiscal policy in accordance with fiscal rules.** The Republic of Serbia (RS) proposed to the National Assembly adoption of the Law Amending the Law on RS Budget for 2011 (budget revision). The basis for the budget revision is the modified fiscal framework for general government and individual government levels that has been agreed by the Memorandum of Economic and Financial Policies (Memorandum) between the RS Government and the International Monetary Fund (IMF). The Memorandum envisages an increase of the general government fiscal deficit from 4.1% of GDP to 4.5% of GDP.

**The Fiscal Council assesses that the raising of the consolidated deficit from 4.1% of GDP to 4.5% of GDP is in conformance with fiscal rules and economically justified.** The raising of the fiscal deficit is a consequence of lowered estimate for real GDP growth in 2011 from 3% to 2%. Lower economic growth leads, according to fiscal rules, to increased fiscal deficit. Viewed from the angle of current fiscal trends, the slow-down in the recovery of economic activity resulted in a considerable decline of tax revenues. Therefore, in accordance with fiscal rules but also in the spirit of a good economic policy, the fiscal deficit growth by 0.4% of GDP (about 13 billion dinars) is allowed as this growth is approximately equal to the assessed decline of tax revenues in 2011 relative to the plan at the beginning of the year. However, total amount of consolidated public expenditures has practically remained unchanged despite the deficit increase.

**Lowering of estimated real GDP growth from 3% to 2% in 2011 and from 4% to 3% in 2012 is justified.** The Fiscal Council analyzed, in line with the legal obligations, the assumptions which have pursuant to fiscal rules led to increased deficit. The Council assessed reliability of the assessed slow-down of economic activity and concluded that the lowering of GDP real growth estimate from 3% to 2% in 2011 and from 4% to 3% in 2012 – is justified (Section 1.1). The latest macroeconomic data and relevant international analyses additionally confirm that economic activity in the South-East Europe is registering a significant slow-down in mid-year, so that for almost all countries in the regions the economic growth estimates are revised downwards (Table 2). Due to great uncertainties with regard to economic developments until the end of the year, the Fiscal Council (FC) believes that there are risks that economic growth in 2011 could be even lower than 2%, and that fiscal policy adjustment envisaged by the budget revisions – is timely and economically desirable. In Section 1.2., FC analyzed and explained why according to fiscal rules and as a consequence of smaller economic growth a somewhat larger fiscal deficit is allowed.

**FC analysis has shown that the drop in tax revenues is principally due to the deceleration of economic activity.** The analysis further shows that the real drop in the most important public revenues: VAT, personal income tax and contributions for social insurance has been almost uniform and ranged from 5-6%. The extent, uniform decline, as well as the trend indicating that tax revenues particularly fall in mid-year (when economic activity decelerates), indicate that the cause for the fall in public revenues needs to be sought in the trends of some of the basic macroeconomic aggregates rather than in bad planning of budget revenues or in the rise of fiscal indiscipline. The trends of the most significant macroeconomic bases for tax collection, which are also closely related with GDP – personal income and consumption – show that they are precisely those that are declining in real terms and resulting in the drop of public revenues (Section 2.3). Indeed, the public revenues analysis has additionally confirmed that weaker than expected economic growth is the cause for the decrease of public revenues as it has had a negative

impact on the tax base. Under such circumstances, allowing automatic increase of fiscal deficit by the amount by which tax revenues have approximately fallen is economically justified.

**Total level of public expenditures remains unchanged relative to the plan at the beginning of the year.**

Fiscal deficit increase by about 13 billion dinars is in accordance with fiscal rules; however, as it is exclusively the consequence of the drop in public revenues against the plan, there is no room, and no economic justification, either, for increase of public expenditures relative to the original plan.

**The structure of public expenditures has to change significantly, however, so as to allow their total level to remain unchanged.**

According to fiscal rules in the Budget System Law, wages and pensions are indexed in accordance with the rise of inflation and one-half of GDP growth from the preceding year. At planning the budget, the NBS estimates of 2011 inflation trends and the RSO estimate of the real GDP growth in 2010 were used. As the inflation was higher than expected, outlays for wages and pensions in 2011 will exceed by about 16 billion dinars those planned at the beginning of the year. In spite of this increase relative to the plan at the start of the year, FC estimates that the trend of wages and pensions is compliant with fiscal rules and that the decline of the wage and pension share in GDP which will take place in 2011 will also ensure the necessary decline in the share of current public expenditures in GDP. Apart from wages and pensions, expenditures for social welfare will also be larger relative to the plan at the beginning of the year by about three billion dinars because they are also largely indexed by inflation. In order for total expenditures to remain on the level unchanged relative to the plan at the beginning of the year, a saving of about 19 billion dinars will have to be realized on the remaining public expenditure items.

**FC estimates that the planned saving is feasible by the end of the year, but that there is also a risk that all necessary savings will not materialize in full.**

The saving plan until the year-end is defined by the Memorandum agreed upon with the IMF and represents the base for the budget revision. The greatest challenge for the fiscal policy will be to achieve the saving of about 12 billion dinars in the domain of purchase of goods and services. The level of realization of this expenditure item in the first seven months of 2011 indicates that its large adjustment will be necessary in the remaining part of the year. Otherwise, the envisaged budget goals will not be accomplished. Decrease of interest payment expenses by about three billion dinars is in line with the FC expectations, while planned drop in consolidated expenditures for public investments is assessed as feasible but economically undesirable (Section 3.1).

**FC view is that the Memorandum has realistically assessed the decline in public revenues in 2011 by about 12 billion dinars, but that there are risks for revenues to be even smaller than planned.**

Public revenues of the consolidated government in 2011 were by the new estimate from the Memorandum reduced by about 12 billion dinars. FC believes this estimate to be mildly optimistic and that there is a certain risk, particularly pronounced in estimated revenue from excise tax and income tax, for these revenues to be smaller than planned by a total amount from 5 to 10 billion dinars (Section 3.2).

**At the Republic level will be necessary an additional decrease of expenditures by about eight billion dinars due to the application of the Law Amending the Law on Local Government Financing.**

If viewed by different government levels, a marked redistribution of budgetary assets has taken place. On the basis of the Law Amending the Law on Local Government Financing, to local governments in Serbia will belong, starting from 1 October 2011, 80% instead of the hitherto 40% of the income tax collected on their territory. Consequently, revenues and expenditures at local level will increase, while at the

Republican level additional savings of about eight billion dinars will have to be made in order to compensate the surrender of tax revenues to local governments (Tables 10-12).

**The Republic of Serbia 2011 budget revision was designed in accordance with the fiscal framework defined on the basis of fiscal rules and the agreed upon Memorandum.** The said fiscal framework limits a possible deficit increase at the Republican level by approximately 13 billion dinars, taking into account that the fiscal result will on all other government levels remain approximately identical against the plan from the beginning of the year.

**The biggest savings realized by the revised budget result from the cut of capital expenditures and own revenues of spending units.** In the draft budget revision, estimate of the Republic 2011 revenues was reduced by about 19 billion dinars due decelerated economic activity and surrender of revenues to local governments. On the expenditure side of the budget, legal obligations of the Republic based on larger than planned allocations for wages, social welfare and transfers to the PIO Fund increased the expenditures by about 18 billion dinars against those envisaged by the Budget Law. Accordingly, total savings that had to be realized at the Republic level – in order for the Republic deficit to be within the allowed limits of the 13 billion dinars growth – amount to about 24 billion dinars. Such a large adjustment could not be achieved without gross, *ad hoc*, caps on the spending of spending units' consumption. The bulk of savings was provided by the cut of capital expenditures and expenditures financed from own assets of the spending units (Table 13).

**FC assesses as economically undesirable the envisaged decline in capital expenditures of the Republic by 8.1 billion dinars.** Deficit adjustment by reduction of capital investments is not desirable taking into account the positive contribution of investments to the development. The rationale for the budget revision indicates that strategically important investment projects of the country will not be abandoned, i.e. that the priorities will be cared for at reducing the capital expenditures. Although it may be that some investment projects (not to materialize due to the revision) are not fully justified in economic terms, FC believes that the short time for the preparation of the budget revision did not allow make all necessary analyses that would clearly support this view. Also, FC noted a delay in implementation of certain projects at the Republican level so that it is possible that all of the originally planned capital expenditures would not be realized anyway (Section 5.2).

**FC does not deem as economically justified to adjust the Republican budget expenditures by smaller spending of own revenues of the spending units.** It has been planned to save by the end of the year a total amount of nine billion dinars in the manner according to which the spending units (Environment Protection Fund, RS Waters Budget Fund, Treasury, and Ministry of Justice) shall gather own assets in an amount larger than the one they will spend. Making savings on these items is not economically justified and can mean that the imposts on the economy and citizens on the basis of the pertaining fees are too high and need to be reduced, or that competent spending units do not fully perform their respective roles.

**The Republican budget revision confirms that the Law Amending the Law on Local Government Financing is not fiscally neutral.** Negative fiscal effects on the Republic budget in the amount of eight billion dinars, which will take place by commencement of the new Law implementation, had to be forcibly compensated. This also involves the earlier described cut of public investments and the planned, highly gross limitations on the spending of own assets gathered by certain spending units which are performing socially useful functions (Environment Protection Fund, Republic of Serbia Waters Budget Fund).

**According to FC, public debt will by the end of the year remain below the legal limitation of 45% of GDP, even after the new borrowing of the Republic by the one billion dollars worth Euro Bonds issue.** However, the public debt has come close to the legally defined limit of 45% of GDP, which additionally requires a strict application of fiscal rules and a gradual decrease of fiscal deficit.

**The Law on Restitution increases the public debt within the limits set by the Budget System Law, and will not endanger the macroeconomic stability of the country.** The value of the bonds to be issued based on restitution is two billion euros. At the time of the bonds issue (in 2015), their relative value will be below 6% of GDP in 2011. FC believes, therefore, that the public debt increase based on the Law on Restitution is in accordance with a responsible fiscal policy and will not have a negative impact on the macroeconomic stability.

## ASSESSMENT OF THE DRAFT LAW AMENDING THE LAW ON THE REPUBLIC OF SERBIA 2011 BUDGET

### 1. ECONOMIC ACTIVITY AND BUDGET DEFICIT

#### 1.1. Assessment of Economic Activity Trends

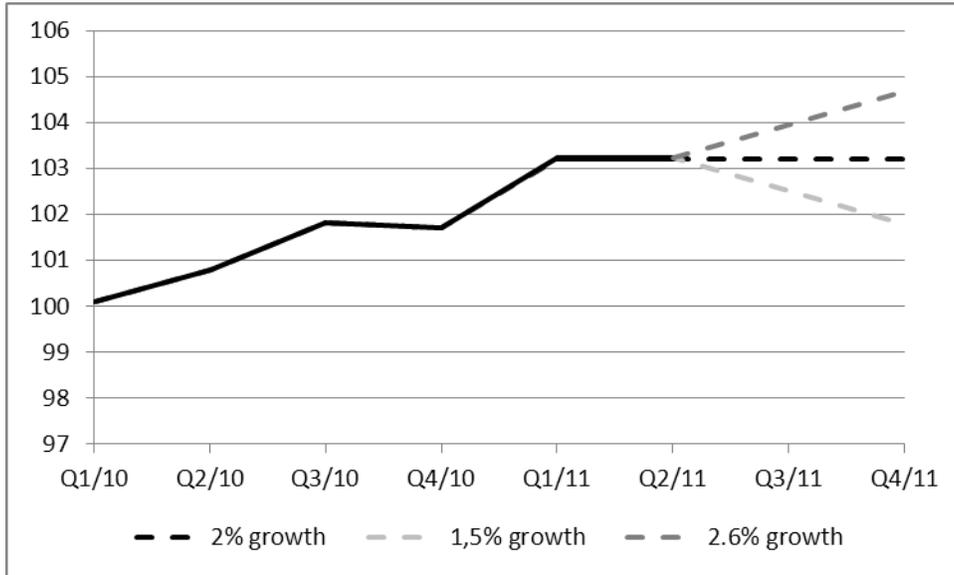
In the circumstances of unchanged fiscal policy, economic activity represents the basic determinant of public revenues and fiscal deficit. Therefore, below will be analyzed the economic developments in 2011 and their bearing on the public revenues and deficit.

**FC analysis shows that lowering by the IMF of the real GDP growth estimate in Serbia from 3% to 2% in 2011 and from 4% to 3% in 2012 is justified.** The lowering of the estimate was due to the stoppage of the recovery of both domestic and European economy, as well as to the high degree of uncertainty with respect to economic trends in the next period. The said lowering of GDP growth estimate involves, on the basis of fiscal rules, an increase of allowed general government's fiscal deficit in 2011 from 4.1% to 4.5% of GDP.

**Indicators of economic activity in Serbia show a stoppage of the post-crisis economic recovery in the second quarter.** Preliminary estimate of the Republic Statistics Office (RSO) is that the growth of GDP in the second quarter was 2.2% year-over-year, which actually represents stagnation of the production against the first quarter when year-over-year GDP growth rate was estimated at 3.4%. The trend of economic activity is best demonstrated by seasonally adjusted GDP growth indexes, presented in Graph 1. Depending on whether the stagnation in production was temporary in the second quarter or whether it will also extend to the second half of the year, overall growth of economic activity will change in 2011 and also in 2012.

Graph 1 presents various possible scenarios for the GDP trend by the end of the year. Scenario *one* supposes continued stagnation by the end of the year. In that case, GDP growth in 2011 would be around 2%. Scenario *two* supposes possible aggravation of the negative trends by the end of the year, and is based on the movements of essential economic indicators from June and July. Final outcome of this scenario is the GDP growth in 2011 of about 1.5%. Scenario *three* supposes return of production to an upward path – to the trend of recovery from the past year. If this trend materialized, total GDP growth in 2011 would be about 2.6%.

**Graph 1. Recovery of production since 2010 with growth projections until end of 2011**



**FC expects stagnation of production to continue until the year-end.** Trends of the essential macroeconomic indicators over the past several months indicate that this year will most probably end with the stagnation of production, as presented in scenario one, although a mild fall in economic activity is not excluded. This is the reason why the GDP growth estimate for 2011 of about 2% is viewed by the FC as realistic and mildly optimistic. The low growth trend or stagnation in production with which the year 2012 will start will entail a fall in the GDP growth in 2012 (from 4% to 3%).

**Most of the observed economic activity indicators show deceleration in mid-year.** Industrial production growth index points to the growth of industrial production in the first seven months of 2011 of 3.5% against the same period a year earlier. In mid this year, however, industrial production slowed down significantly relative to the start of the year. At the end of the second quarter, it was down by about 1% relative to the first quarter, and dropped by additional 1.5% in July against June. In July was also for the first time in 2011 registered the year-over-year fall in industrial production by 3.2%.

Growth of *exports* was high in the first seven months - 21.6%. However, in the second quarter exports manifested characteristics similar to those of industrial production. Seasonally adjusted exports dropped in the second quarter by about 2% against the Q1, and this trend also continued in July when exports register additional slight fall relative to June figure (0.3%).

*Retail trade* has been at a low level throughout the year (real turnover in retail trade was in the first seven months of 2011 by about 15% smaller than a year ago). Retail trade turnover index is an indicator of the trends taking place in the trade sector, but is also important as one of the indicators of the domestic demand trends. In mid-year, the retail trade turnover index points to even more unfavorable trends than at the start of the year which manifest in the decline of seasonally adjusted values of that index. In July, the retail trade turnover index dropped by additional 0.9 percentage points against the preceding month.

Growth of the *financial sector* has been positive in 2011, but it also decelerated in mid-year primarily as the result of smaller credit activity of the banks. Real year-over-year credit growth dropped from 14.6% in March to 12.1% in June and to 10.4% in July. Further slow-down in this sector is possible due to the increase of non-performing loans and the higher country risk and the related more expensive borrowing abroad. EMBI (*Emerging Market Bond Index*) for Serbia and for the entire South-East European region has been increasing strongly. The particularly fast rise of this index was recorded in late August and early September. At the end of September, EMBI for Serbia exceeded 600 base points, or was by about 250 base points above its April level.

More difficult capital inflow in Serbia in the next period is possible for the fact that some of the leading banks in Serbia that are in foreign ownership are faced with a possible crisis on their own respective markets. Under such circumstances, it is hard to expect an inflow of capital into Serbian branches from their parent banks before those markets stabilize.

*Employment* is not offering, either, any signs of recovery that was expected at the beginning of the year. The number of the employed in June did not change against May and, according to official RSO records is 1,755 million. Relative to the same period of the preceding year, the number of employed is by around 55 thousand smaller.

On the side of possible positive impacts on economic activity trends, possible growth of *agriculture* in the third quarter needs to be singled out. Relatively high prices of agricultural commodities on the world markets could spur Serbian exports, and the good agricultural season would also have a favorable influence on the growth of food industry. However, the drought in August and September significantly reduced the yields of corn, which is one of the most important agricultural crops in Serbia, so that positive effect of agriculture on GDP growth will be smaller than expected.

FC opinion is that all of the observed indicators point to stagnation of the economy in the second half of the year, which would result in a total GDP growth of about 2% in 2011. Although there is a possibility for this growth to be somewhat higher, more certain are the risks of additional slow-down of exports and of capital inflows due to the unfavorable developments in Europe, in which case GDP growth in 2011 could be even lower than the estimated 2%. Data about the trends of the most important components of aggregate demand, employment and real earnings, which are analyzed in section 2.3, also corroborate the justification of a smaller GDP expected growth.

**The latest relevant international analyses point to deceleration of the world economy.** International analyses estimate that most countries in the world, particularly in Europe, will register in 2011 a growth smaller than expected. Such estimate is supported by the data about the world trade which registered stagnation in the second against the first quarter for the first time after almost two years of continuous growth, and the marked deceleration of the growth of the majority of world economies in the second quarter, considerably below all expectations.

The OECD September analysis indicates that leading European economies will register in 2011 a growth smaller than estimated a few months ago, and also points to a high uncertainty with respect to economic trends in the remaining part of the year. The last IMF *World Economic Outlook* also points to a similar conclusion.<sup>1</sup> In September, the IMF revised downwards the estimated GDP growth rates in 2011

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<sup>1</sup> Sub-title of this document is: „Slowing Growth, Rising Risks“ and speaks in illustrative manner about the current events taking place in the world economy.

and in 2012 for most countries in the region. Table 1 presents the latest IMF estimates and the differences against those in April.

**Table 1. IMF's GDP Real Growth Estimates in 2011 and 2012, Countries in the Region**

	September estimate		April estimate		Difference	
	2011	2012	2011	2012	2011	2012
Albania	2.5	3.5	3.4	3.6	-0.9	-0.1
Bosnia and Herzegovina	2.2	3.0	2.2	4.0	0.0	-1.0
Bulgaria	2.5	3.0	3.0	3.5	-0.5	-0.5
Croatia	0.8	1.8	1.3	1.8	-0.5	0.0
Hungary	1.8	1.7	2.8	2.8	-1.0	-1.1
Macedonia	3.0	3.7	3.0	3.7	0.0	0.1
Montenegro	2.0	3.5	2.0	3.5	0.0	0.0
Romania	1.5	3.5	1.5	4.4	0.0	-0.9
Serbia	2.0	3.0	3.0	5.0	-1.0	-2.0

Source: IMF, World Economic Outlook Database

## 1.2. Economic Activity and Fiscal Rules

**Fiscal rules enable pursuing anti-cyclical fiscal policies.** Anti-cyclical fiscal policy means saving “in good years” in order to be able to stimulate production in “bad years” by a larger budget deficit. Consistent application of anti-cyclical fiscal policy influences, on the one side, alleviation of economic crises and, on the other, saving in „good years“ reduces the public debt, external deficit and inflation. Empirical analyses have shown, however, that in most countries (including Serbia) a much stronger preference was shown for pursuing the anti-cyclical fiscal policy when it increases the government deficit than when it leads to surplus. By the amendments of the 2010 Budget System Law, in Serbia the anti-cyclical policy postulates built into the fiscal rules so that they have become a legal obligation, both in the case of low and high economic growth.<sup>2</sup> Annual fiscal deficit is determined by the formula<sup>3</sup> which also cares for the speed of economic recovery – a higher economic growth reduces the fiscal deficit and a lower allows a higher deficit.

**Lowering of GDP growth estimate in 2011 from 3% to 2% according to fiscal rules leads to deficit increase from 4.1% of GDP to 4.5% of GDP.**<sup>4</sup> GDP growth of 3%, planned at the beginning of the year according to the fiscal rules formula, gives the allowed budget deficit in 2011 of 4.1% of GDP. The lowering of GDP growth estimate by one percentage point (from 3% to 2%), according to the fiscal rules formula, automatically resulted in allowed deficit increase by 0.4% of GDP (from 4.1% of GDP to 4.5% of GDP).

**Increase of allowed budget deficit in 2011 to 4.5% of GDP is a consequence of smaller public revenues rather than of larger expenditures.** Economic growth lower than planned results also in smaller than planned tax revenues. In that case, the desirable anti-cyclical fiscal policy allows the fiscal deficit to

<sup>2</sup> Natural rate of GDP real growth in Serbia, which is a benchmark for assessing if the economic activity growth is high or low, is 4%.

<sup>3</sup> Article 27 e of the Budget System Law

<sup>4</sup> Fiscal deficit is shown in percentages of GDP.

increase by approximate amount representing the drop in tax revenues, while expenditures remain approximately the same. FC estimate is that the keeping of unchanged fiscal deficit from the beginning of the year would not be economically justified under the mentioned circumstances. Namely, when economic activity decelerates, neither tax increase nor public expenditures decrease is desirable. It is particularly worth mentioning that increase of allowed deficit according to fiscal rules does not mean increase of public expenditures. Rather, total amount of public expenditures must remain approximately the same relative to the plan at the beginning of the year.

**Freeze in total public expenditures at the planned level is a key as it enables automatic adjustment of the deficit.** Even in the case of subsequent acceleration of economic activity, which would enable achieve in 2011 the originally planned GDP growth of 3% (which is believed by FC as little probable), the fiscal policy would automatically adjust. Namely, as public expenditures remain unchanged under any type of circumstances, and as public revenues would in the case of accelerated economic activities reverse the trend and start rising, the deficit would automatically decrease and again come closer to the originally planned value of 4.1% of GDP.

**Consistent application of the fiscal rule also involves downward revision of fiscal deficit during the year.** Fiscal deficit also needs to be revised downwards if it is assessed that economic growth in the current year will be higher than planned. Because of the slower than planned recovery in 2011, and in accordance with fiscal rules, the recommendation of the Fiscal Council was to be allowed the 2011 fiscal deficit to increase from 4.1% of GDP to 4.5% of GDP. The Fiscal Council assessed as economically desirable to adjust the current fiscal policy by budget revision if in the course of the year a significant change occurs in macroeconomic environment. Such interpretation of fiscal rules imposes an obligation on the Fiscal Council to recommend to the RS Government to reduce the fiscal deficit in the case where the Fiscal Council will assess that economic activity is rising significantly faster than planned.

## **2. FISCAL TRENDS IN THE FIRST SEVEN MONTHS OF 2011**

### **2.1. Public expenditures trends in the period January-July 2011**

**Public expenditures of the general government registered a fall in real terms in the first seven months of 2011 against the same period of the preceding year, but are still somewhat higher than planned.** Consolidated public expenditures of the general government were in the period January–July 2011 equal to 801.7 billion dinars, which was by 9.4% more in nominal terms, and by 3.2% less in real terms against the same period of 2010. In this way, the necessary decrease of public expenditures share in GDP was accomplished, taking into account that in the first half of the year was registered the GDP growth at estimated level of about 2.5%. Decrease of the share of public expenditures in GDP is necessary so as to allow the fiscal deficit to decrease in the medium run and ensure sustainability of the public finance. Comparative analyses indicate that the level of public spending realized in 2010, which was 45.6% of GDP, as well as the one planned for 2011 (43.7% of GDP) is too high. Therefore, achieving a smaller deficit by reducing expenditures is also economically desirable.

**Table 2. Trend of Consolidated Public Expenditures in the Period January–July 2011**

	Billion dinars		Growth rate (2011/2010, %)	
	I–VII 2010	I–VII 2011	Nominal	Real
<b>PUBLIC EXPENDITURES</b>	733.0	801.7	9 .4	-3 .2
Current expenditures	679.6	737.1	8 .5	-4 .0
Employment expenditures	174.2	189.5	8 .7	-3 .8
Purchase of goods and services <sup>1)</sup>	116.3	134.0	15 .2	1 .9
Interest payment	18.0	25.7	42 .7	26 .3
Subsidies	40.7	43.0	5 .6	-6 .5
Social welfare and transfers	330.3	345.0	4 .4	-7 .6
<i>of which pensions</i>	227.2	240.4	5 .8	-6 .4
Capital expenditures	38.9	46.7	20 .0	6 .2
Net budgetary lending	14.5	17.9	23 .3	9 .1

<sup>1)</sup> Purchase of goods and services includes Other current expenditures according to IMF methodology

**To the real fall of public expenditures against the preceding year mostly contributes the legally regulated indexation of wages and pensions.** Although pension and wage outlays are in nominal terms slightly larger than planned for this year, the application of fiscal rules in connection with their indexation has anchored them, economically viewed, at acceptable level. In addition to wages and pensions, a solid real decline against 2010 is also registered by subsidies as a consequence of gradual abolishment of the anti-crisis Government measures. Relative to the past year, the largest real growth was in the case of interest expenses that are rising due to larger deficits from the preceding year and the rise of the public debt (Table 2).

**Positive is the change of the public expenditures structure where the share of current expenditures in GDP is falling and the share of investments rising.** Current public expenditures in the first seven months of 2011 dropped by 4%, while capital expenditures registered a real growth of 6.2%. Although capital expenditures increased significantly both in nominal and real terms over the past year, this fact is relativized by the fact that the value of public investments, as well as their ratio to GDP, is further low (about 3.5%). In the phase of infrastructure building and modernization, a desirable share of public investments in GDP needs to be about 5% of GDP.

**The priority of the budget revision is to keep, by reducing spending, the planned amount of total public expenditures until the year-end.** In order for the consolidated government deficit to satisfy the fiscal rules defined by the Budget System Law, it will be necessary to keep until the year-end all public expenditures at the level equal to that at the beginning of the year. Economically speaking, reduction of expenditures by the end of the year is more desirable in current expenditure items and less desirable in planned investments.

## 2.2. Public Expenditures Deviation from Budget Framework Planned for 2011

**Without additional savings, public expenditures in 2011 would by end of the year overshoot the planned amount by about 24 billion dinars.** Although the real level of public expenditures and their share in GDP in 2011 will decline, their nominal level will exceed the level defined by the law if the measures of saving are not applied. The trend of public expenditures in the first seven months indicates that they will in 2011 be by about 16 billion dinars above the plan. Moreover, by the end of the year the negative fiscal effect of the application of the Law on Local Government Financing, estimated by the FC to be worth additional eight billion dinars, will also be felt. Therefore, revision of public expenditures which would enable savings between 20 and 25 billion dinars is indispensable in the remaining part of the year if the budget goals set for 2011 pursuant to fiscal rules are to be accomplished.

**Allocations for wages, pensions and social welfare are nominally larger than planned due to higher inflation.** According to fiscal rules, in 2011 was envisaged wage and pension indexation in April by the inflation level from the January-March period, and in October for the inflation level in the April-September period and one-half of the real 2010 GDP growth. At planning the budget, the NBS estimate of 2011 inflation trends and the RSO estimate of real 2010 budget growth were used. According to those estimates, public wages and pensions were planned to be raised in April by 2.95% and in October by 2%. As in the January-March 2011 period the growth rate of consumer prices was 5.5% or higher than expected, wage and pension increase in April was 5.5% instead of the planned 2.95%.<sup>5</sup> Consequently, wage and pension expenditures were in the first seven months by about six billion dinars larger than planned, and will until the end of the year exceed the budget plan by about 16 billion dinars (wages by nine billion and pensions by seven billion dinars). Due to the higher than planned inflation, allocations from the budget were also larger for a portion of the social welfare the indexation of which is legally linked to consumer price movements and, accordingly, they will be by about 3.5 billion dinars larger than planned by the year-end.

**Other expenditures of the consolidated government were in the first seven months of 2011 mostly in accordance with the plan.** Table 3 shows the percentage of realization of individual budget items in the first seven months of 2011 against the assets planned for the whole year. In column 2 is the percentage or public expenditures realization in the first seven months of 2010, for orientation purposes. The higher percentage of realization than the one a year ago points to the risk of overshooting the planned framework by the end of the year, while smaller percentage points to the possibility of saving in the same period. FC does not use this analysis at analyzing the trend of expenditures for public wages and pensions which are defined by the law and do not depend on the degree of realization in the past period of the year.

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<sup>5</sup> In October, wage and pension increase is expected to be about 1.5% instead of planned 2% mainly due to the revised GDP growth in 2011 (from 1.8% to 1%).

**Table 3. Percentage Realization of Public Expenditures in the First Seven Months against Total Annual Expenditures**

	Realization in seven months against annual plan (2011) and annual realization (2010)	
	<b>2011</b>	<b>2010</b>
<b>PUBLIC EXPENDITURES</b>	54.7	53.9
Current expenditures	55.8	55.5
Employment expenditures	57.6	56.6
Purchase of goods and services <sup>1)</sup>	52.8	51.6
Interest payment	51.6	52.7
Subsidies	51.1	52.3
Social welfare and transfers	57.2	57.0
<i>of which pensions</i>	57.7	57.7
Capital expenditures	39.4	37.0
Net budget lending	64.6	48.4

<sup>1)</sup> Purchase of goods and services also includes Other current expenditures in accordance with the IMF methodology

**Three billion dinar savings on interest is probable.** One can note in Table 3 that the realization of almost all analyzed expenditures is usual and expected in the part of the year under review. A larger than usual deviation is noted in the value of net budget lending for which was in the first seven months of 2011 spent almost two-thirds of the total assets planned for the year. Last year, in the same period, for these purposes was spent only 48% of total annual expenditures. The reason for deviation in 2011 is the Government's joint venture with FIAT in the first half of the year. As this one-time increase at the start of the year was planned at preparing the budget, net budget lending will most probably remain within the framework planned for the whole year. On the other side, savings in interest payment item are already almost certain in 2011, which are estimated to be about three billion dinars. Savings will be achieved thanks to somewhat lower exchange rate than the one planned at the start of the year. Analysis of the remaining expenditures indicates that realization of capital expenditures and of purchase of goods and services is slightly faster than in the same period of the preceding year, while realization of subsidies is somewhat slower. These oscillations are still within the limits of usual deviations during the year; FC expects, therefore, that their total annual realization will be in compliance with the budget plans.

**Expenditures of the general government will additionally increase by about 8 billion dinars because of fiscal decentralization.** Based on June amendments of the Law on Local Government Financing, fiscal revenues on the local level will increase at the expense of decrease of the Republican budget revenues. Accordingly, local governments will have a possibility to increase their expenditures by a total amount of up to eight billion dinars, i.e. by the amount by which the revenues of local government units will go up in 2011.

**Necessary is the revision of consolidated public expenditures to ensure savings from 20 to 25 billion dinars by end of the year.** Savings are necessary to make up for the government expenditures increase by about 16 billion dinar (net effect of larger expenditures for wages, pensions and social welfare and interest savings), and the negative fiscal effect of the implementation of the Law on Local Government Financing (about eight billion dinars).

### 2.3. Public Revenues Trend in the January-July 2011 period

**Real decline of public revenues is considerably faster than that of expenditures.** Consolidated public revenues of the general government realized in the January-July 2011 period totaled 712.7 billion dinars, which is by 6.7% more in nominal terms and by 5.6% less in real terms against the first seven months of 2010. The relatively sharp real drop of public revenues in the first seven months of 2011 was registered in almost all months of the period under review, and accelerated particularly in June and July.

**Real fall of public revenues in the first seven months of 2011 is considerably sharper than planned for the year.** At preparing the 2011 budget, real fall of public revenues of the general government was planned to be 1.1%, or significantly below the fall registered in the first seven months of 2011. Continuation of the existing trend would also mean realization of smaller than planned real value of public revenues at the level of the whole 2011.

**Unfavorable developments in the economy, speeding up after the first quarter of 2011, are the basic cause for the pronounced fall of the real public revenues level.** Economic activity (GDP) is rising at a slower pace than planned when preparing the 2011 budget and the most important macroeconomic bases for tax collection – personal income and spending – are registering a marked real decline. Continuation of the trade liberalization, as well as the change of personal consumption structure towards more sizeable consumption of less taxed subsistence products additionally influence on the drop of real public revenues. Moreover, in the circumstances of deteriorating macroeconomic trends, additional decrease of the rate of tax collection probably occurred, both in the form of a possible rise of tax evasions and in the form of non-payment of reported tax obligations. The number of employers who file with the competent tax authorities the tax returns with full amounts of taxes and contributions is rising; however, they do not pay them due to the liquidity and solvency difficulties they are facing. The last two columns of Table 4 illustrate that the realization of public revenues, in real amounts, is considerably worse than the planned real trend on which the 2011 budget was based.

**Table 4. Trend of Consolidated Public Revenues in the January-July 2011 Period**

	billion dinars		Growth rate (2011/2010,%)		
	I-VII 2010	I-VII 2011	Nominal	Real	Planned (real) <sup>1)</sup>
<b>PUBLIC REVENUES</b>	668.1	712.7	6.7	-5.6	-1.1
Current revenues	667.1	711.0	6.6	-5.7	-0.5
Tax revenues	582.4	626.1	7.5	-4.8	-0.4
Citizens income tax	77.7	83.2	7.1	-5.2	-3.2
Corporate profit tax	20.3	24.5	20.9	7.0	6.9
VAT	179.7	192.4	7.0	-5.2	1.7
Excises	74.1	87.8	18.5	4.9	7.6
Customs duties	24.0	21.5	-10.3	-20.6	-18.4
Other tax revenues	25.3	24.0	-4.9	-15.8	-5.0
Contributions	181.3	192.7	6.3	-5.9	-2.6
Non-tax revenues	84.7	84.9	0.2	-11.3	-1.4
Capital revenues	0.2	0.7	204.7	169.7	-100.0
Donations	0.9	1.0	20.6	6.7	-77.8

<sup>1)</sup> Plan (I-XII 2011)/Realization (I-XII 2010), in 2010 constant prices

**In the January-July 2011 period, all categories of public revenues registered a real drop, except revenues from excises and corporate profit tax.** Real drop in the most important public revenues: VAT, personal income tax and contributions for social insurance is almost uniform, ranging from 5-6%. The most pronounced decline in the category of current revenues was registered by customs revenues, followed by other tax revenues and non-tax revenues. The drop of customs revenues results from further decrease of the tariff rates on importation of commodities from European Union countries, and real appreciation of the dinar against the euro in the seven-month period under review. The growth of imports value in euros was insufficient to compensate the negative impact of the listed factors.

**Decline of VAT revenues reflects the reduced real value of personal consumption.** Also, it is possible that due to the lower standard of living the structure of personal consumption shifts in the direction of increased share of subsistence consumption and consumption of subsistence products taxed at the lower VAT rate of 8%. Personal consumption represents an approximate macroeconomic rate for VAT calculation and collection. Taking into account that for the time being the Republic Statistics Office (RSO) does not estimate personal consumption developments at quarterly level, for personal consumption estimate in Serbia is most often used the turnover in retail trade. According to statistical data, the turnover in retail trade in the first seven months of 2011 fell by 14.2% in real terms. This indicator cannot be viewed, however, as impartial and as a precise indicator of personal consumption trends because it does not involve some important forms of personal consumption, such as subsistence consumption, consumption of utility services, electric power, telecommunication services, catering, tourist, health and other services. In crisis periods, retail trade turnover probably overestimates the real decline in personal consumption because some forms of consumption are inelastic or their elasticity relative to the level of income is very low (subsistence consumption, utility services, health services, education, etc.), and are not included in the retail trade turnover. Although retail trade turnover is not an adequate indicator of the level and intensity of the real level of personal consumption, it still indicates the direction in which personal consumption moves.

**In the absence of relevant statistical data, personal consumption was estimated on the basis of the total wage and pension bill developments.** Wages and pensions are the major source of personal consumption funding in Serbia because they account for about 85% of citizens' available income. Moreover, indexation of some other forms of income (social welfare, etc.) may be expected similarly to that of wages and pensions, and even to have a similar growth. Due to the crisis in the West European countries and relatively modest share in average household's income, it is not realistic to suppose that remittances could have risen significantly in the current year and thus change the trend of the real level of the total income of households in Serbia. In the first half of 2011, real wage bill fell by about 5%, whereas real pension bill dropped by about 7%. Accordingly, total incomes of households declined by about 6% in real terms. On assumption that the limit inclination to consumption recorded at the beginning of the year has not changed, it follows that real decline of personal consumption in Serbia was about 6% in the first half of 2011. As VAT revenues fell by 5.2% in the first seven months of 2011, in the Fiscal Council's view it is precisely the decline of personal consumption, caused by real drop of citizens' income, which represents the basic reason for the decline of revenues from VAT.

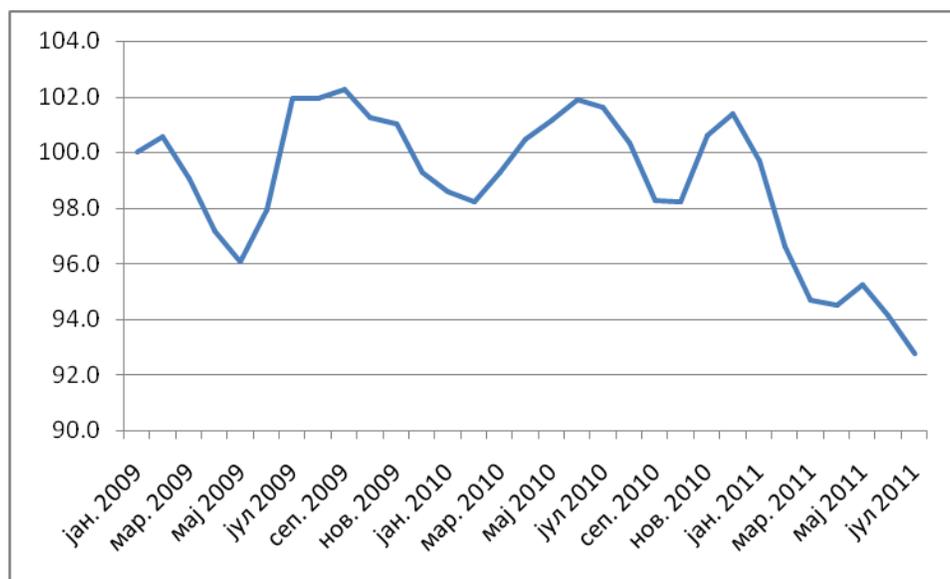
**Revenues from excises registered in the January-July 2011 period were by 4.9% up in real terms against the same period of the preceding year.** However, in June and July negative tendencies were registered with this fiscal form, too. The growth of real level of excises revenues is a consequence of implicit excise increase in the course of 2011. However, the growth of real level of excise revenues in the first seven months of 2011 is smaller than the growth planned in 2011. Smaller than planned growth of excise revenues is a consequence of several possible factors: purchase of oil derivatives in the

neighboring countries by citizens living in the border-areas and also reduced consumption of cigarettes or consumers' reorientation to cheaper cigarette brands.

**Revenues from personal income tax and contributions for obligatory social insurance realized in the January-July 2011 period were down in real terms by 5.2% and 5.9%, respectively, against the same period of 2010.** The drop in these types of revenues arises primarily from the fall in registered employment and in real wages in the period under review. Decrease of employment in the first half of 2011 was 3.1% on average (the last available data about the employment trends relates to June), while average wage dropped by 1.9% between January and July 2011. Accordingly, the wage bill dropped in the period under review by 5% in real terms against the same period of 2010. Although income tax and contributions are mostly calculated on the same base, the drop of revenues from contributions registered in the period under review was sharper than the fall of revenues from income tax. The latter could be a consequence of the diminished fiscal discipline of employers and/or a more significant growth of the types of natural persons' incomes not subject to payment of contributions (income from capital, lease of real estate, capital gains, and the like).

**FC's estimate is that the growth of revenues from the profit tax is partly due to the abolishment of exemptions based on employment of new workers,** which has entered into force in this year. In addition, some sectors of the economy registered a better performance in their operation than in 2009, which directly influenced on the rise of their liability based on the profit tax in 2011, taking into account that thus type of tax is paid in advance during the year on the grounds of the performance achieved in the preceding year. The sharp real drop of other tax revenues in the period between January and July 2011 against the same period of 2010 is of a lasting nature as it represents the consequence of the abolished tax paid on mobile telephony.

**Graph 2. Fixed Base Index of Seasonally Adjusted Consolidated Real Public Revenues (2010 average=100)**



**The trend of real level of public revenues by months presented in Graph 2 indicates that tendencies are deteriorating in the course of 2011.** The deteriorating trend of the real level of public revenues can also be illustrated by movements of cumulative public revenues rates. As Table 5 shows, the

deteriorating trend of consolidated public revenues has been evident since April of this year. If analyzed by tax forms, the deterioration is particularly pronounced in the case of consumption tax (VAT, excises and customs revenues). Unlike consumption taxes, personal income tax and contributions registered a sharp and stable real drop in the first seven months of 2011.

**Table 5. Cumulative Public Revenues Real Growth Rates 2011/2010**

	Real growth rate (2011/2010, %)						
	I	I-II	I-III	I-IV	I-V	I-VI	I-VII
<b>PUBLIC REVENUES</b>	-1.6	-0.2	-2.2	-4.2	-3.7	-4.4	-5.6
Current revenues	-1.7	-0.3	-2.3	-4.3	-3.8	-4.5	-5.7
Tax revenues	-2.3	-0.7	-2.6	-4.3	-4.0	-4.5	-4.8
Personal income tax	-6.5	-4.9	-6.7	-6.1	-5.7	-4.9	-5.2
Corporate profit tax	-6.8	-13.1	9.9	6.5	7.1	6.8	7.0
VAT	-1.3	0.3	-2.1	-3.8	-2.8	-5.1	-5.2
Excises	13.9	23.6	14.4	7.1	7.4	6.8	4.9
Customs revenues	-10.2	-12.9	-15.4	-17.9	-18.9	-20.2	-20.6
Other tax revenues	-8.2	-3.5	-6.8	-10.5	-13.1	-15.1	-15.8
Contributions	-7.9	-6.0	-7.2	-7.3	-7.1	-6.1	-5.9
Non-tax revenues	4.1	3.5	-0.4	-4.3	-2.1	-4.4	-11.3
Capital income <sup>1)</sup>	4809.2	3102.8	3351.3	3047.9	2304.6	158.0	169.7
Donations	41.6	26.1	10.4	18.1	34.6	21.8	6.7

<sup>1)</sup> Capital public revenues are relatively small; therefore, large percentage oscillations are possible

#### 2.4. Deficit Trend of the General Government and Republican budget

**Deficit of the general government is high due to unfavorable trends of public revenues that are lower than planned and expenditures somewhat larger than planned in the first seven months.** After the seven-month period, consolidated public revenues totaled 712.7 billion dinars and consolidated public expenditures 801.7 billion dinars. Thus, the general government deficit reached the figure of 89.0 billion dinars. The consolidated budget deficit is considerably larger than the one usual for this part of the year. In the first seven months was realized 63.4% of the total deficit planned for the whole year, while in the same period of 2010 the deficit realization was 47.7% of the total.

**Even worse are the results of the Republican budget.** Revenues of the Republican budget after eight months of the year amount to 440.0 billion dinars, and expenditures to 542.3 billion dinars. The Republic budget deficit reached the figure of 98.4 billion dinars, or as much as 81.7% of planned annual deficit of the Republican budget. After the first eight months of last year, the deficit was 67.2%.

**Deficits are significantly above the planned ones.** The budget deficit realized in the period between January and July (January-August at the Republic level) is assessed as significantly exceeding the planned levels: a shortfall was registered on the side of revenues while expenditures were somewhat higher than would be expected in this part of the year. Taking into account the trends of both revenues and expenditures, it is clear that the originally planned deficits of the general government and the Republic will not materialize.

### 3. ASSESSMENT OF THE NEW BUDGET PLAN FOR THE GENERAL GOVERNMENT IN 2011

#### 3.1. Analysis of Agreed General Government's Public Expenditures Framework

The Republic of Serbia Government and the International Monetary Fund have agreed on the Memorandum of Economic and Financial Policies (Memorandum). The Memorandum defines a framework for consolidated revenues and expenditures movements by 2011-end, as well as a basis for the Republic budget revision.

The Memorandum has defined robust corrective interventions in the structure of public expenditures. Fiscal rules are the starting basis for the correction of consolidated public expenditures, which involves keeping expenditures on practically unchanged nominal level against the plan at the year start. Keeping the expenditures on the initially planned nominal level is indispensable in order for the fiscal deficit to remain within the limits set by fiscal rules. In the framework of total expenditures, the Memorandum recognizes an increase of expenditures for wages, pensions and social welfare due to higher than planned inflation (by about 19 billion dinars). Also, local government expenditures were increased by about eight billion dinars because of the start of application of the amended Law on Local Government Financing. In order to keep total expenditures unchanged, significant savings are foreseen relative to the plan of expenditures, mostly on the Purchase of Commodities and Services and Capital Expenditure items. FC believes that such a plan is necessary, it is compliant with fiscal rules, but that there are also strong risks for non-materialization of all planned savings by the end of the year.

**Table 6. Estimated Trend of General Government Public Expenditures in 2011  
(billion dinars)**

	Original plans	Memorandum	Difference
<b>PUBLIC EXPENDITURES</b>	1,465.6	1.467.0	1.4
Current expenditures	1,319.2	1.324.8	5.6
Employment expenditures	328.8	337.9	9.1
Purchase of goods and services	253.3	241.3	-12.0
Interest payment	49.9	46.8	-3.1
Subsidies	84.2	85.5	1.3
Social welfare and transfers	603.0	613.3	10.3
<i>of which pensions</i>	440.2	447.2	7.0
Capital expenditures	118.7	115.4	-3.3
Net budgetary lending	27.8	26.8	-1.0

**Current expenditures are allowed to increase, and capital expenditures and net budget lending are to decline.** If viewed by type of expenditures, the agreed upon Memorandum envisages an increase of consolidated current expenditures by 5.6 million dinars against the plan at the beginning of the year, which will be mostly compensated by a cut of capital expenditures by 3.3 billion dinars against those planned for this year. Also, expenditures for net budgetary lending are now lower by about one billion dinars (Table 6).

**In the framework of current expenditures, allocations for wages, pensions, social welfare and subsidies are foreseen to increase, and allocations for the purchase of goods and services and interest to decline.** A sharp redistribution of budget assets takes place in the framework of current expenditures. Allocations for wages are increasing by 9.1 billion dinars, allocations for pension by 7 billion dinars,<sup>6</sup> those for social welfare by 3.3 billion dinars, and for subsidies by 1.3 billion dinars. Savings are to materialize on expenditures for goods and services (12 billion dinars) and interest payment (3.1 billion dinars). FC has analyzed individual expenditure items from the plan agreed upon by the Memorandum.

**Assessed wage increase in excess of the plan is realistic.** As to the structure of current expenditures, employment expenditures are assessed to be by 9.1 billion dinars above the plan. Starting from the hitherto trend and estimated wage trend by the end of the year, Fiscal Council finds the assessment from the Memorandum as founded.<sup>7</sup>

**Estimated increase of social welfare and transfers, including pensions, is realistic.** According to the Memorandum estimates, total social transfers will be by 10.3 billion dinars above the plan, while pensions, as a part of social transfers, will be by seven billion dinars in excess of those planned. In view of estimated annual values of pensions and social expenses, the Fiscal Council finds that the Memorandum estimate of social transfers is realistic.<sup>8</sup>

**The Memorandum envisages sharp cuts in expenditures for the purchase of goods and services by the end of the year which, in view of the Fiscal Council is possible but with significant risks.** According to the agreed Memorandum, the item Purchase of Goods and Services will be by as much as 12 billion dinars lower than the plan. On the basis of nominal and real trends, as well as the realization of expenditures for the purchase of goods and services in the period January-July of this year, the Fiscal Council holds that an extraordinary restrictive policy will have to be pursued in this particular public expenditures item and that it could pose a problem for full implementation of the plan.

**Estimated decline of interest expenditure of the general government is in conformance with the results of Fiscal Council's analysis.** According to the Memorandum, interest payment will be by about 3.1 billion dinars less than planned. Real growth of interest payment in this year is high after the first seven months (26.3%); however, it was planned as such during the 2011 budget preparation. In view of the dinar appreciation and lower interest burden on this basis, the assessed expenditures for interest payment as envisaged by the Memorandum is correct and the value of this item will be smaller than planned for 2011.

**Estimated allocation for subsidies of the general government is within the limits of FC expectations.** The Memorandum estimate is that at the general government level allocation for subsidies will by 1.3 billion dinars above the plan for 2011. The trend of these expenditures and the percentage of their realization in the first seven months indicate that realization of subsidies is approximately at the expected level or even somewhat below the expectations for this part of the year (Table 3). Taking into account that major portion of subsidies is seasonally allocated in the second half of the year, a moderate subsidy increase of the consolidated government relative to the plan (by 1.3 billion dinars) in 2011 is in the FC view within the limits of expected deviations and is realistically estimated.

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<sup>6</sup> It needs to be taken into account that real wage and pension level will be lower than in the preceding year in spite of their higher than planned increase. In this way is ensured the necessary decline of their share in GDP. Decrease of the wage and pension share in GDP is a key measure for reducing the share of public spending and fiscal deficit in GDP.

<sup>7</sup> See section 2.2.

<sup>8</sup> See section 2.2.

**Envisaged decrease of capital expenditures of the general government relative to the initial plan is feasible but requires certain adjustment of several spending units' plans.** According to the Memorandum, capital expenditures in this year will by 3.3 billion dinars be down relative to the plan at the start of the year. After seven months of this year, capital expenditures are registering a real growth (by 6.2%) and a high degree of realization (compared with that at the same time last year). It is interesting to note, however, that although the rise of investment expenditures at the consolidated level is slightly faster than the plan, the rise is a consequence of two divergent trends. Namely, capital investments at the republican level are considerably lagging behind relative to the plan, and other spending units (JP „Putevi Srbije“, local governments) are realizing them faster than the plan. The reason for the delay at the Republican level may be the abolishment of the special ministry for the National Investment Plan (NIP) and the procedural changes that followed, rather than lagging behind in implementing the strategically important government investments. Therefore, smaller allocations for capital outlays relative to the plan at the beginning of the year actually means that considerable savings at the republican level will be achieved due to slower execution of planned projects, while other budget users (JP „Putevi Srbije“, local governments) will be slightly increasing their capital expenditures relative to the plan at the start of the year – but not to the extent indicated by the faster realization in the first half of the year.<sup>9</sup>

**Moderate lowering of net budget lending of the general government requires significant deceleration of the pace in realization of these expenditures.** The Government and the IMF estimate that net budget lending in this year will be somewhat smaller than planned (more specifically, by one billion dinars down against the plan). The exceptionally high year-over-year growth (9.1%) and the degree of realization relative to the original plan (64.6%) in the first seven months of the year point to possible overshooting of the planned value by several billion dinars rather than to realization below the planned figure. Although the bulk of net lending increase was the one-time increase in the first half of the year, or the consequence of the meeting of contractual obligations of the joint RS Government and FIAT investment, the shortage of the remaining assets in this chapter points to a strong financial discipline that will be required in order for net lending to remain within the planned framework.

### **3.2. Analysis of estimated 2011 public revenues from the Memorandum of Economic and Fiscal Policies**

**Public revenues in 2011 adjusted by the Memorandum are realistic in view of the Fiscal Council.** However, there are risks for some public revenues to be below expectations. If these risks materialize, total public revenues in 2011 could be by 5 to 10 billion dinars lower than estimated by the Memorandum.

**FC assumes no change in the fiscal system, but expects improved collection.** No major changes in the fiscal system by the end of the year were assumed at estimating the public revenues; however, it was at the same time assumed that certain activities are possible which would lead to an improved collection of tax obligations. Estimate for total public revenues of the consolidated government sector in 2011 as a whole is based on the realized revenues of the consolidated government sector in the period between

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<sup>9</sup> Taken as a whole, public investments will even after the last savings keep in this year their share in GDP unchanged relative to the preceding year, taking into account that their relatively high growth had been initially planned for 2011. It will be necessary to significantly raise in the medium term the level of allocation for investments so as to enable the country to build a modern infrastructure within a reasonable term.

January and July 2011, as well as on the revenues of the Republican budget in August 2011 and projected developments of basic macroeconomic aggregates by the end of 2011. As no change in the tax system is expected, the revenues in the remaining part of the year will crucially depend on the developments of macroeconomic aggregates, and particularly on personal consumption and personal income with the latter depending predominantly on the trends in the area of employment and wages. Macroeconomic aggregates will in the remaining part of the year be under the influence of both the seasonal factors and cyclical developments of macroeconomic aggregates (production, employment, consumption, and others).

**Seasonal factors will have a positive impact on consolidated public revenues trend in the remaining part of the year.** It will also hold true for the most important fiscal forms. Positive seasonal influence on public revenues is a consequence of the systemic form according to which the level of economic activity, consumption and wages is higher in the second half of the year than in the first six months.

**Estimated influence of cyclical factors on public revenues in the rest of the year is less probable.** Cyclical trend of macroeconomic aggregates depends on a larger number of factors; some of them which are important are not under the government control (world economic developments, climatic factors influencing on agriculture and food industry), and some are under the government control in a medium run only (change of the economic system). Estimates of world economic developments in this and in the next year most often are between expected slow-down in the recovery and a new recession that is announced; for the time being, however, the estimate of decelerated recovery is dominant. Because of the high level of public debt and fiscal deficit, the Government of Serbia does not have room for applying short-term measures that would additionally stimulate the economy through public consumption growth. Accordingly, it is still uncertain whether the negative trends in the area of consumption present since the second quarter will stop or will continue. It is not certain, either, what trend of employment will be like. Will stagnation continue or will unemployment increase? Answers to these questions largely depend on the developments in the world economy so that for the time being the most probable forecast is that we are facing a decelerated recovery rather than a new recession.

**Growth of Serbian economy in 2011 is expected to be about 2% instead of the earlier planned 3%.** From the tax revenues point of view, trends in employment, wages and personal consumption are of particular importance. In conformance with the estimate that a new recession is not expected, a small increase of unemployment is expected by the end of the year. It is also expected that real wages and personal consumption will in the rest of the year rise relative to the level recorded at mid-year, i.e. that their trends will be determined by seasonal factors. Inflation trends are also necessary to be taken into account at projecting the nominal revenues, apart from the above enumerated real factors. On the basis of the results achieved in the first seven months, the expected real trend of macroeconomic aggregates and the expected rate of inflation, in the Memorandum was adjusted the estimate of consolidated public revenues in 2011 (representing the base for the Republican budget revision or for determining the allowed deficit). The Fiscal Council will further in the text analyze this public revenues estimate and focus on possible risks due to which, even if general assumptions materialize (of particular importance being the assumption of expected deceleration of the growth of Serbian economy, rather than a new recession) revenues could be smaller than projected and deficit would thereby be higher than allowed.

**According to revised projections, consolidated public revenues in 2011 will nominally be somewhat smaller than those planned for 2011.** Nominal consolidated public revenues are by about 1% (or by 11.7 billion dinars) smaller relative to the plan. This result is a consequence of the sharp real drop of macroeconomic aggregates (consumption, employment, wages) relative to the plan, in spite of the fact

that due to the higher than planned inflation nominal public revenues have increased during the year. On the basis of the trends in the passed period of the year and expected trends of macroeconomic aggregates by the end of the year, the Fiscal Council estimates that there is a risk for consolidated public revenues in 2011 to be lower than by the estimated 5 to 10 billion dinars as envisaged in the Memorandum.

**Revised projections indicate that the largest deviation of the realized relative to planned amount of revenues will be in the case of VAT revenues (-14.5 billion dinars).** VAT revenues in 2011 can be estimated on the basis of VAT collected in the first seven months of 2011 and based on the analysis of personal consumption trend which represents an approximate macroeconomic base for VAT revenues. Assuming that neither a new recession nor acceleration of economic recovery will take place by the end of the year, FC expects that personal consumption and VAT will rise only under the influence of seasonal factors. The Fiscal Council's estimate obtained in this way indicates that VAT revenues projected in the Memorandum are realistic.

**Table 7. Estimate of Nominal Public Revenues Trend in 2011  
(billion dinars)**

	Original plans	Memorandum	Difference
<b>PUBLIC REVENUES</b>	1,325.3	1,313.6	-11.7
Current revenues	1,323.5	1,311.7	-11.8
Tax revenues	1,152.7	1,140.0	-12.7
Personal income tax	147.6	150.7	3.1
Corporate profit tax	38.2	38.2	0.0
VAT	355.9	341.4	-14.5
Excises	178.9	180.4	1.5
Customs revenues	39.6	39.8	0.2
Other tax revenues	47.9	46.0	-1.9
Contributions	344.7	343.4	-1.3
Non-tax revenues	170.8	171.7	0.9
Capital revenues	-	0.0	0.0
Donations	1.8	1.8	0.0

**There is a pronounced risk for excise revenues to be by about 5 billion below the planned figure.**

Namely, the projection of total excise revenues in 2011 is by 1.5 billion dinars in excess of the initially planned revenues. However, taking into accounts the tendency from the first eight months of the year, particularly the negative June and July tendencies, as well as the trend with regard to the volume and structure of excise products consumption, the Fiscal Council holds that there is a high risk for revenues from excises to be below the current expectation.

**There is also a certain risk that customs revenues could be lower than those planned by the Memorandum.** The projection of customs revenues in 2011 is slightly above the initial plan (by 0.2 billion dinars). Based on the developments in this year, in the Fiscal Council's view the customs revenues estimate represents the possible upper limit of annual revenues and that there are risks that this type of revenues could be somewhat lower than estimated by the Memorandum.

**Growth of income tax revenues will perhaps be a little smaller than estimated in the Memorandum, while estimate of contributions is viewed as realistic.** Revised estimate of public revenues shows that in 2011 revenues from income tax will be higher than planned (by 3.1 billion dinars), and revenues from contributions smaller (by 1,3 billion dinars). As income tax and contributions are mostly collected on the same tax base, a major deviation in the trend of these revenues is not to be expected, as a general rule, although some deviations were registered in the preceding period. As the decline of revenues from income tax and contributions was in the first seven months of 2011 sharper than planned, mainly due to the reduced wage bill, and as no significant rise of wages and employment is expected by the end of the year, FC holds that the growth of revenues from income tax will be smaller than provided in the revised estimates, while estimate given for revenues from contributions is deemed realistic. According to FC, revenues from income tax could be at the level of the initial plan, instead of the expected growth as presented in the Memorandum.

**Estimate of profit tax revenues is highly conservative.** According to the Memorandum estimate, total revenues from this tax in 2011 will not change relative to those planned, but realized revenues can likely be somewhat higher relative to the plan. Namely, a possible decline of economic activity in the second half of 2011 would not significantly reflect on the trend of revenues from this tax in 2011. It would reflect in 2012 when the tax on the profit realized in 2011 will be paid.

Estimates given for other tax revenues and for other types of public revenues are assessed as realistic.

### 3.3. Analysis of Fiscal Policy by End of 2011 per Different Levels of Government

**The sharpest decline of revenues relative to the original plan is at the level of the Republic, while at the local government level expenditures are increasing most.** Relative to the plan at the beginning of the year significant changes haven taken place in revenues and expenditures at different government levels. The Republican budget will suffer the major changes on the revenues side, because the revenues of the Republic will decline due to the deceleration of the economic activity by about 8.5 billion dinars and by additional 10.5 billion dinars based on the beginning of application of the Law on Local Government Financing.<sup>10</sup> On the other side, local governments will have the biggest growth of expenditures as at the local level expenditures will increase by about nine billion dinars relative to the plan at the beginning of the year.

**Table 8. Change of Revenues per Different Government Levels Relative to the Plan at the Start of the Year (billion dinars)**

	Revenues <sup>1)</sup>		
	Original plans	Memorandum	Difference
Republic with own revenues	805.0	788.5	-16.5
Republic by narrower definition	726.4	707.3	-19.1
Own revenues	78.5	81.1	2.6
Local governments and Vojvodina	228.9	238.8	9.9
RZZO	193.8	191.1	-2.7

<sup>10</sup> Expenditures of the Republic for transfers to local governments will decline by about 2.5 billion dinars. Thus, total net effect in 2011 of the application of the Law on Local Government Financing on the Republican budget deficit is about eight billion dinars.

PIO Fund	442.8	449.8	7.0
PIO Fund excluding transfers	254.8	255.7	0.9
NSZ	26.3	25.2	-1.1
JP Putevi Srbije	37.2	37.1	-0.1
<b>General government (consolidated)</b>	<b>1325.3</b>	<b>1313.6</b>	<b>-11.7</b>

**By the revision, the Republican budget deficit by narrower definition (without own revenues of the spending units) will go up by 22.2 billion dinars.** It is mainly the consequence of the decline of budget revenues by the amount of 19.1 billion dinars and, to a smaller extent, of the increase of the Republican budget expenditures by 3.1 billion dinars. In the Republican budget by narrower definition could not be fully provided the savings to compensate the increase of expenditures for wages and transfers to social funds (pensions and social welfare) in the amount of around 17 billion dinars<sup>11</sup> and about eight billion dinars of the net negative fiscal effects of the implementation of the Law on Local Government Financing.

**Table 9. Change of Expenditures per Different Government Levels Relative to the Plan at the Start of the Year (billion dinars)**

	Expenditures <sup>2)</sup>		
	Original plans	Memorandum	Difference
Republic with own revenues	925.5	922.2	-3.3
Republic by narrower definition	846.9	850.0	3.1
Use of own revenues	78.5	72.1	-6.4
Local governments and Vojvodina	241.2	250.0	8.8
RZZO	193.8	191.1	-2.7
PIO Fund	442.8	449.8	7.0
NSZ	26.3	25.2	-1.1
JP Putevi Srbije	38.8	38.7	-0.1
<b>General government (consolidated)</b>	<b>1466.2</b>	<b>1467.0</b>	<b>0.8</b>

**It has been planned that the necessary additional savings at the Republic level be realized from own revenues of the spending units at the level of nine billion dinars.** The Memorandum envisages that some budgetary beneficiaries that have own resources do not spend nine billion dinars of their revenues by the end of the year whereby at consolidated level would be realized the fiscal objectives in 2011. Achievement of the said savings requires adoption of a credible plan at the central government level which would specifically envisage the savings per spending units. Also, it is not only that such adjustment would be difficult to implement, it can neither be a part of a sustainable fiscal policy.<sup>12</sup>

<sup>11</sup> To the Republican budget is fully shifted the larger than planned increase of allocations for pensions, because by that amount increase the transfers from the Republic to the PIO Fund and by far the largest part of wage increase and allocation for social welfare. Thus, out of a total of 19 billion dinars increase of public expenditures due to indexation higher than planned, 17 billion dinars spilled over to the Republic level.

<sup>12</sup> See section 5.2.

**Table 10. Change of Deficit by Different Government Levels Relative to the Plan at the Start of the Year (billion dinars)**

	Deficit		
	Original plans	Memorandum	Difference
Republic with own revenues	-120.5	-133.7	-13.2
Republic by narrower definition	-120.5	-142.7	-22.2
Own revenues	0.0	9.0	9.0
Local governments and Vojvodina	-12.3	-11.2	1.1
RZZO	0.0	0.0	0.0
PIO Fund	0.0	0.0	0.0
NSZ	0.0	0.0	0.0
JP Putevi Srbije	-1.6	-1.6	0.0
<b>General government (consolidated)</b>	<b>-140.3</b>	<b>-153.4</b>	<b>-13.1</b>

**Local governments and PIO Fund will have expenditures larger than the plan.** According to estimates, local government expenditures will exceed the plan by 8.8 billion and those of PIO Fund by 7 billion dinars. The said estimates arise from fiscal decentralization (when local government expenditures are concerned) and from the inflation higher than the plan and, accordingly, higher than expected pension indexation. In both cases, the growth of expenditures is practically provided for at the expense of the Republican budget balance. Namely, local government will increase their revenues (and expenditures) in the manner that a part of the taxes that earlier belonged to the Republic will be earmarked for the local level, and as the PIO Fund does not collect sufficient assets with which to meet its obligations, the entire pension increase is provided by increased transfers from the Republican budget.

#### 4. PUBLIC DEBT IN 2011

**At July-end 2011, public debt of Serbia reached the level of EURO 13.6 billion, which is 41.3% of estimated GDP.** Relative to the start of the year, public debt increased by EURO 1.4 billion (about 4.6 p.p. of GDP), but its share in GDP remained approximately unchanged due to the appreciation of the dinar which has a strong impact on the public debt/GDP ratio in the circumstances where 80% of the debt is nominated in foreign exchange. In standard circumstances, the public debt trend is closely related with the fiscal deficit level. However, in the first seven months of 2011, the growth of public debt is by about EURO 530 million higher than the amount of the government consolidated deficit in the same period. This difference arises from the fact that the government was borrowing in order to timely provide assets necessary to finance the fiscal deficit and repay the principal of the debts falling due in the coming months. As a consequence of the difference in the debt and deficit trends, the government formed during the first seven months of 2011 new deposits of more than EURO 500 million. In mid-September, the deposits were at the level of about EURO 630 million.

**By end of 2011, the public debt will remain below the cap of 45% of GDP.** The projection of borrowing by the end of 2011 depends on the extent to which the government will either be using the accumulated deposits or opt for further borrowing. FC analysis shows that by the recent issue of Eurobonds worth about EURO 700 million sufficient assets have been provided and that there will be no need for the government borrowing and further debt increase. Namely, according to fiscal rules observed in the Government and IMF agreement, total fiscal deficit in 2011 may be 153.4 billion dinars.

It further means that the deficit in the August-December period may be around 64 billion dinars. Taking into account the already available relatively high government deposits and the new borrowing based on the issue of Eurobonds, it follows that there will be no need for a new government borrowing by the end of the year. Moreover, the issue of Eurobonds has provided assets for covering a substantial portion of deficit in the first half of next year. If the mentioned plans realize, public debt at the close of 2011 would be about EURO 14.3 billion, or about 43.5% of GDP.

**Due to the inclusion of the obligations based on restitution, the upper public debt limit defined by fiscal rules will be around 50% of GDP.** The draft Law on Restitution envisages public debt increase by about two billion euros. In view of the Fiscal Council, the effect of this Law on the public debt is within the allowed limits described in the Budget System Law and do not affect the macroeconomic stability. Fiscal rules define the public debt upper limit at 45% of GDP, excluding the restitution related obligations. As the draft Law meets the defined fiscal criteria, the limit of allowed public debt will rise to the level of about 50% of GDP after the Law's application.

## 5. REPUBLICAN BUDGET REVISION

### 5.1. General budget revision assessments

**Revision is compliant with the agreement of the Government and IMF.** Revision of the Republican budget (which includes own revenues of the spending units) is harmonized with the framework agreed upon in the Memorandum of Economic and Fiscal Policies. The starting base for the budget revision involves the allowed increase of consolidated deficit from 4.1% of GDP to 4.5% of GDP, or the consolidated deficit increase of about 13 billion dinars in nominal terms. However, the Republican budget deficit was by the revision increased by about 22 billion dinars. In order for 2011 fiscal targets to be met and to bring down the deficit to 13 billion dinars, additional savings of nine billion dinars were needed at the republican level. It was planned that such savings be realized on own revenues of the spending units (Table 11). It means that some spending units having their own revenues (Environment Protection Fund, RS Waters Budget Fund, Treasury and Ministry of Justice) in 2011 will not spend a part of assets raised from the pertaining fees and administrative duties and, accordingly, will realize a substantial fiscal surplus by the end of the year.

**Revenues of the Republican budget were revised downwards by about 19 billion dinars.** On the revenues side of the Republican budget, it was estimated that due to decelerating economic activity and start of implementation of the Law Amending the Law on Local Government Financing, budgetary revenues of the Republic would significantly decline. The decline of the Republican budget revenues relative to the projections from the Budget Law is about 19 billion dinars, of which amount 10.5 billion dinars are assets surrendered to the local government.

**Expenditures of the Republican budget were revised upwards by 3.2 billion dinars.** On the expenditures side, relative to the assets envisaged by the Budget Law, allocations for wages, social welfare and pensions<sup>13</sup> were increased by about 18 billion dinars. A part of this increase is compensated by budget revision through savings on other expenditures of the Republic (capital expenditures, interest,

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<sup>13</sup> Transfers to PIO Fund

net budgetary lending, etc.), so that total increase of the Republican expenditures was by the revision brought down to 3.2 billion dinars (Table 11).

**Envisaged reduction of the Republican budget revenues by 19 billion dinars is justified.** FC believes that due to the slow-down of economic activity and start of implementation of the amended Law on Local Government Financing the decrease of revenues by 19 billion dinars is justified. However, taking also into account the continued slow-down of economic activity in the third quarter, FC estimates that there is a risk of additional decline in the republic revenues. The risks are mainly posed by excise revenues items. If these risks materialize, the republican revenues could go down by additional 4-8 billion dinars by the end of the year.

**Planned savings are feasible.** FC estimates possible realization of savings that would help bring down the increase of the Republican budget expenditures to the envisaged amount of 3.2 billion dinars. Increased allocations for wages, pensions and social welfare of almost 18 billion dinars relative to the original budget are justified and compliant with fiscal rules and FC's estimate of the deviation of public expenditures from the plan for this year.<sup>14</sup> Expenditures for interest payment are relative to the initial budget reduced by 2.8 billion dinars, net budgetary lending (outlays for acquisition of financial property) are revised downwards by 1.1 billion dinars, transfers to local governments are cut by 2.5 billion dinars (in accordance with the amended Law on Local Government Financing), and capital expenditures by 8.1 billion dinars. Total net effect on the Republican expenditures is the increase of expenditures by 3.2 billion dinars, which is considered by the FC as realistic since realization of the mentioned savings is feasible.

**Table 11. Revised 2011 Budget (in thousands of dinars)**

	<b>2011 budget</b>	<b>Revised budget</b>	<b>Difference</b>
<b>TOTAL REVENUES AND RECEIPTS OF THE REPUBLIC</b>	<b>726,400,000</b>	<b>707,345,000</b>	<b>-19,055,000</b>
<b>1. Tax revenues</b>	677,200,000	657,845,000	-19,355,000
1.1. Personal income tax	79,100,000	71,100,000	-8,000,000
1.2. Corporate profit tax	35,000,000	35,100,000	100,000
1.3. Value added tax	355,800,000	341,355,000	-14,445,000
1.4. Excises	160,100,000	161,625,000	1,525,000
1.5. Customs	39,600,000	39,765,000	165,000
1.6. Other tax revenues	7,600,000	8,900,000	1,300,000
<b>2. Non-tax revenues</b>	49,200,000	49,500,000	300,000,
<b>TOTAL EXPENDITURES OF THE REPUBLIC</b>	<b>846,919,905</b>	<b>850,091,802</b>	<b>3,171,897</b>
<b>Current expenditures</b>	788,760,626	801,143,689	12,383,063
Employment expenditures	196,745,456	204,128,033	7,382,577
Purchase of goods and services	47,871,107	47,528,996	-342,110
Interest payment	44,926,001	42,111,729	-2,814,271
Subsidies	54,568,952	54,389,353,	-179,598
Transfers to obligatory social insurance organizations	274,302,042	280,074,899	5,772,857
- Republic pension and disability insurance fund	230,900,000	238,100,000	7,200,000
Other appropriations and transfers	1,456,002	1,318,002	-138,000
Social welfare from the budget	88,155,887	91,520,871	3,364,984

<sup>14</sup> For more details about the reasons for increased allocation for wages, pensions and social welfare, see section 2.2

Other current expenditures	12,401,272	13,624,018	1,222,746
<b>Capital expenditures</b>	31,483,694	23,432,227,	-8,051,466
<b>Outlays for acquisition of financial property</b>	26,675,585	25,515,885	-1,159,700
<b>DEFICIT OF THE REPUBLIC</b>	<b>-120,519,908</b>	<b>-142,746,803</b>	<b>-22,226,895</b>
<b>Own revenues and donations</b>	78,547,313	81,140,235	2,592,922
<b>Expenditures financed from own revenues</b>	78,547,313	72,140,235	-6,407,78
<b>DEFICIT OF THE REPUBLIC WITH OWN REVENUES</b>	<b>-120,519,908</b>	<b>-133,746,802</b>	<b>-13,389,4588</b>

**The Fiscal Council keeps reservations with respect to realization of the planned savings of nine billion dinars on the Spending Units' Own Revenues item.** The revised budget plans total assets from donations and own revenues of the spending units in the amount of 81.1 billion dinars, or corresponding expenditures from these assets of 72.1 billion dinars. The Fiscal Council's reservations relate to the size of planned savings and to economic justification of such a type of adjustment.

## **5.2. Basic Risks to Implementation, and Economic Justification of the Most Measures Envisaged by Revised Budget**

**Adjustment of expenditures through smaller spending of the own revenues will be a challenge by the end of the year.** It has been planned to save a total of nine billion dinars of own revenues (specific purpose stamp taxes, fees – which are collected by certain funds, ministries etc.) . Savings have been planned with the following spending units: 5.15 billion dinars with the Environment Protection Fund, 2.15 billion dinars with the RS Waters Budget Fund, 0.2 billion dinars with the Ministry of Justice, and 1.5 billion dinars with the Treasury. Taking into account that the total amount of own resources of the spending units (donations included) is about 80 billion dinars, planned savings are, in relative terms, very big – they exceed 10% of total own revenues. The Fiscal Council assessment is that planned savings are possible, because in earlier years the spending units would also save a part of own assets – for example, last year savings were at the level of 7 billion dinars. The Fiscal Council feels certain doubts about the plan in terms that only four spending units will be able to realize the necessary savings. A good solution, according to the Fiscal Council, is introduction into the revised budget of an additional guarantee for this plan's implementation. Namely, article seven of the Law Amending the Law on the Republic of Serbia 2011 Budget (revised budget), foresees assessment in mid-November of the overall result based on the financing from the spending units' own revenues. If it shall be found that the limits on spending with the spending units are not sufficient to provide a surplus on their own revenues in the amount of nine billion dinars, the revised budget envisages automatic application of additional caps on the spending financed from own revenues.

**In view of the Fiscal Council, budget adjustment is not fully economically justified by smaller spending of own revenues.** Major portion of own revenues are imposts that the economic sector pays to the state funds (agencies, ministries) for the clearly defined purpose of social significance.<sup>15</sup> Realization of the savings on these items could mean that imposts on the economy on these grounds are too high and that they need to be reduced or that competent spending units do not perform in full their social roles. The Fiscal Council also points out that own revenues of the spending units represent an unusually large

<sup>15</sup> Preservation, sustainable utilization, protection and upgrading of the environment, increase of energy efficiency, use of renewable sources of energy, regulations of streams, protection against harmful effects of waters, protection against pollution, construction, maintenance and management of water systems, etc.

portion of the Republican budget, accounting for over 10% of the budget resources. Such a sizeable flow of assets off direct budget framework makes efficient public finance management more difficult. The Fiscal Council recommends, therefore, that in the next period be reconsidered the justification of some forms of own revenues of the spending units, as well as a possibility of integrating a part of own assets of the spending units with the baseline budget of the Republic of Serbia. This possibility needs also to be considered for the reason that assets saved in this year do not practically come to the central treasury but are carried over for the same purpose in next year. In this way, essential savings are not realized. Actually, spending of own assets is only temporarily deferred whereby the point of current measures gets relativized.

**Cutting capital expenditures in revised budget is not economically desirable.** The largest savings in the Republican budget, viewed by economic classification, are realized on capital expenditures, and amount to 8.1 billion dinars. Deficit adjustment by cutting capital investments is not desirable in view of the positive contribution of the investments to the development. A couple of arguments can partly justify the cutting of capital expenditures.

**First, the essential investment priorities are not abandoned.** The decline of capital expenditures can be partly justified by a better prioritization of investment projects. It is stated in the rationale for the revised budget<sup>16</sup> that capital projects (the Corridor 10 road, building of the Zemun-Borča bridge with the pertaining communication roads, construction of apartment buildings on the location of the former „Stepa Stepanović” barracks in Belgrade, Belgrade city road by-pass) will neither be postponed nor suspended. It is expected, therefore, that planned savings do not relate to the projects of strategic importance for the state. The Fiscal Council’s detailed analysis has partly confirmed that the reduction of capital expenditures does not affect the strategically important projects of the country.<sup>17</sup> Still, the consequences of public investment cutting could be perceived only on the basis of more complete and more detailed explanations. Accordingly, the Fiscal Council holds that in view of the significance of public investments for economic development of the country, it is economically justified to provide a clearer overview and explanation of the envisaged savings at each reduction of capital expenditures in the revised budget.

**Second, the Fiscal Council has noted a delay in implementation of a number of projects so that the initially planned capital expenditures would not be realized.** At the Republic level, the initially planned amount of capital investments would probably not be realized, regardless of the budget revision. Namely, at the Republican level, realization of capital expenditures for the first eight months of 2011 is 9.9 billion dinars, which is only 26% of planned annual expenditures. In the first eight months of last year, realization was 33% relative to the whole 2010, which indicates that realization of capital expenditures of the Republic in 2011 is slower than the plan. A possible reason for the delay at the Republican level is the inefficient implementation of the projects in the frameworks of NIP, which can be partly explained by the abolishment of the special ministry during the fiscal year and the specific administrative difficulties in that connection. As the bulk of several-year long and strategically essential investments of the country are not carried out through NIP, this indication also supports the view that

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<sup>16</sup> See Part II. Rationales for the proposal of necessary resources per spending units (expenditures) from the Draft Law Amending the Law on the Republic of Serbia 2011 Budget

<sup>17</sup> Capital expenditures of the Ministry for Infrastructure and Energy (Transport function) were reduced by two billion dinars. Capital expenditures of the Ministry of Environment, Mining and Spatial Planning (Community Development function) were reduced by 1.1 billion dinars. To several appropriations is applied the decline of capital expenditures (buildings and building structures item) by approximately 200 million dinars, to each of: Ministry of Youth and Sports, Customs Administration, Ministry of Justice.

the reduction of public investments by revised budget, although basically undesirable, will not have marked economic consequences on the economic development of the country.

**The purpose of net budgetary lending of the Republic (not included in deficit increase) increased by 15 billion dinars is not fully explained.** Relative to the initial budget, with the Ministry of Finance, on the economic classification net budget lending, available resources were increased by 15 billion dinars. According to the rationale for the revised budget, these assets are appropriated for subordinated loans to commercial banks. Similarly as assets appropriated for equity capital in the company “Fiat automobili Srbija”, the assets appropriated for subordinated loans to commercial banks are posted „below the line“ and do not increase the deficit. The purpose of these assets in the revised budget is not clear, particularly because only three months remain until the end of the fiscal year, so that introduction of a special budget item in such a limited period is expected to have a concrete reason. In this regard, adoption of the Government amendment (of 27 September), intended to have the said economic classification omitted, would dispel the mentioned dilemmas.

**Revised balance has also shown that the hastily adopted amendments of the Law on Local Government Financing were fiscally irresponsible.** On the basis of the Law Amending the Law on Local Government Financing, starting from 1 October 2011 to local governments in Serbia will belong 80%, instead of the hitherto 40%, of income tax realized on their territory. It is evident in the revised budget that the Law Amending the Law on Local Government Financing is not fiscally neutral, but has negative fiscal effects on the Republican budget in the amount of eight billion dinars which will have to be compensated. As the Republican budget cannot systematically compensate such a sizeable loss of revenues over a short term, the revised budget has practically envisaged coercive and economically non-desirable measures that will offset the negative fiscal effects of the implementation of the amended Law on Local Government Financing. These measures involve the above described reduction of public investments and planned, highly gross limitations on the spending of gathered own assets of some spending units (Environment Protection Fund, RS Waters Budget Fund, etc.).