Republic of Serbia
Fiscal Council

Assessment of Fiscal Rules Compliance in 2011

In conformance with Article 92e of the Budget System Law, the Fiscal Council is presenting an independent assessment of the compliance of fiscal rules in 2011. The Fiscal Council holds that in 2011: 1) the general fiscal rule concerning the general government deficit level was not fully accomplished; 2) the general fiscal rule concerning the public debt level was violated, and 3) the special fiscal rule determining the pension and pubic sector salaries trend was observed.

The 2011 fiscal deficit was slightly in excess of the permitted limit (by 5 billion dinars or by 0.15% of GDP) due to the smaller than planned public revenues inflow, and not because of total public expenditures increase. A real danger for Serbia public finance is in establishing unfavorable trend of public revenues which will most probably continue in 2012 as well. It is for this reason that the Fiscal Council is already assessing that further adjustments will be necessary do as to have the deficit remain within the planned framework in 2012, and that in the absence of such adjustments it could easily increase to over 5% of GDP.

At the close of 2011, the public debt deficit reached 46.4% of GDP, which is above the legal limit of 45% of GDP. The public debt of Serbia rose in 2011 by EUR 2.3 billion, while its share in GDP increased by 2.2 percentage points. The Fiscal Council analysis demonstrates that further increase of the public debt is inevitable in 2012 due to the low growth of GDP and planned fiscal deficit of 4.25% of GDP. According to Fiscal Council assessment, the public debt will at the end of 2012 most probably be around 51% of GDP. Accordingly, It is believed that violation of the fiscal rule which defines the public debt limit of 45% of GDP is of a permanent rather than temporary nature, which requires adoption of the measures simultaneously with the 2012 budget revision, which will halt the public debt rise and return it, over the medium term, below the legal limit of 45% of GDP.

Fiscal Rule Concerning General Government Deficit in 2011

In 2011, the fiscal deficit of general government was 158.3 billion dinars or 4.7% of GDP, which is a deficit by 5 billion dinars higher than the one planned in accordance with fiscal rules, i.e. 153.4 billion dinars (4.5% of GDP). The deficit somewhat higher than planned is due to the fact that public revenues were by about 10 billion dinars below the revenues planned in September when the Republic revised budget was adopted and the fiscal framework for 2011 defined. The Fiscal Council noted in its September report that public revenues in 2011 could possibly be by between 5 and 10 billion dinars smaller than the plan – which materialized in the end.[1] Public expenditures of general government did not increase against the September planned level. They even dropped by about 5 billion dinars against the plan.

Table 1 presents general government realized revenues, expenditures and deficit against the September plan when the Republic revised budget was adopted and agreed upon the fiscal framework of consolidated government in 2011.

Table 1. Public Revenues and Expenditures in 2011, Plan and Realization

	September Plan	Realization	Difference
PUBLIC REVENUES	1313	1303	-10
Current revenues	1311	1298	-13
Tax revenues	1139	1131	-8
Personal income tax	151	151	0
Profit tax	38	38	0
Value added tax	341	342	1
Excise duties	180	171	-9
Customs revenues	40	39	-1
Other tax revenues	46	44	-2
Contributions	343	347	4
Non-tax revenues	172	167	-5
Capital gains	0	2	2
Donations	2	3	1
PUBLIC EXPENDITURES	1467	1461	-5
Current expenditures	1325	1325	0
Employee expenditures	338	342	4
Purchase of goods and services	241	248	7
Interest repayment	47	45	-2
Subsidies	86	80	-6
Social welfare and transfers	613	609	-4
of which: Pensions	423	423	0
Capital expenditures	115	111	-4
Net budgetary lending	27	25	-2
CONSOLIDATED BALANCE	-153	-158	-5

[1] See for more details: „Assessment of the Proposed Revised RS Budget for 2011" of 30 September, www.fiskalnisavet.rs

If viewed against the revenue plan, the most pronounced shortfall was registered in excise duty based revenues – by about 9 billion dinars. Although the largest part of this dissention resulted from the overly optimistic planning in September (referred to by the Fiscal Council in its September Report), the departure from the plan was also partly technical in its nature. Namely, excise duties are paid on the last day of the month or in the first business days of the next month. At the turn from December to January, the larger portion of excise duties was paid in January which was the reason for smaller revenues in December.

Non-tax revenues also registered a shortfall by about 5 billion dinars against the plan. Non-tax revenues actually comprise a highly heterogeneous group of a larger number of public revenues which makes their analysis and assessment considerably more difficult. The Fiscal Council noted in September 2011 that a significant increase of non-tax revenues had been planned by the year-end. The reason for this increase was the expected inflows from companies in bankruptcy (recovery of past-due government claims) and a somewhat larger income from the dividends of public enterprises. Although details of individual non-tax revenue inflows are not currently available, smaller than planned non-tax revenues may be an indication that some of these non-tax revenues were not realized in full.

The remaining public revenues were generally in accordance with the September plan (Table 1). Slightly larger revenues were registered from contributions and VAT, while somewhat lower than the plan were the revenues generated by customs duties and other tax revenues. The Fiscal Council also noted that the better result achieved in VAT generated revenues had resulted from the postponement of the VAT refund from end of December to the beginning of January. Consequently, VAT revenues were smaller than expected in early January because of the larger refund remaining from December. The Fiscal Council is of the view that VAT based revenues in 2011 would have been smaller than the plan in the absence of the mentioned postponement and that the fiscal deficit would have been additionally higher by about 4 billion dinars.

In 2011, public expenditures were by about 6 billion dinars smaller relative to the September plan. Current expenditures were in compliance with the plan, while savings were recorded in capital expenditures (about 4 billion dinars) and net budgetary lending (around 2 billion dinars).

Although the execution of current expenditures was, if viewed in aggregate, in conformance with the plan, the Fiscal Council has noted major dissentions of a number of items relative to the plan (Table 1). Thus, significant savings were recorded in subsidies (around 6 billion dinars), social welfare allocations – except pensions (about 4 billion dinars), and in interest expense (about 2 billion dinars). However, assets larger than planned were spent for the purchase of goods and services (7 billion dinars) and salaries (4 billion dinars).

If viewed by different government levels, higher than planned deficit was recorded by the Republic budget and local self-government budgets, while obligatory social insurance funds (Pension and Disability Insurance Fund (PIO), Republic Health Insurance Fund (RFZO) and National Employment Office (NSZ)) registered a small surplus – in lieu of planned balance. The Republic budget deficit (together with own revenues of budgetary beneficiaries) totaled 144 billion dinars instead of 140 billion dinars; the local self-government deficit (including Vojvodina) was 16 billion dinars instead of the planned 12 billion; mandatory social insurance funds registered a surplus of 3.5 billion dinars (fiscal result of social insurance funds had been planned to be in balance). Table 2 presents the financial result per different government levels.

Table 2. Financial Result of Different Government Levels in 2011, Plan and Realization

	September plan	Realization	Difference
Republic with own revenues[1)]	-140	-144	-4
Republic by narrower definition	-149	-152	-3
Own revenues	9	8	-1
Local self-government and Vojvodina	-12	-16	-4
RFZO	0	2	2
PIO Fund	0	0	0
NSZ	0	1	1
JP Putevi Srbije (public enterprise)	-2	-1	1
General Government	**-153**	**-158**	**-5**

1) Republic deficit incorporates Project loans

Republic deficit registered a deficit that was by 4 billion dinars higher than the plan. However, this higher deficit principally resulted from the fact that the shortfall of the Republic budget revenues had dropped by as much as 9 billion dinars. Excise duties, in the case of which the shortfall in revenues was the sharpest relative to the plan when compared with other tax revenues, represent mostly the revenues of the Republic budget. In this way, the Republic budget actually had expenditures lower by about 5 billion dinars in spite of the higher deficit.

Essentially, the earlier planned savings in own revenues of budgetary beneficiaries were also realized. According to the September 2011 plan, savings in own revenues of budgetary beneficiaries had to be at the level of 9 billion dinars, of which the amount of 8 billion dinars was realized.

Local self-government made a deficit higher than planned although at the end of the year it was allocated additional 8 billion dinars based on the amended Law on Self-Government Financing. It was planned that the deficit of towns and municipalities was to be around 9 billion dinars and that of AP Vojvodina about 3 billion dinars in 2011. However, the deficit of towns and municipalities was about 15 billion dinars, and the deficit of Vojvodina about 1 billion dinars in 2011. The Fiscal Council is reminding that at drawing up the fiscal framework for 2011 the expectation was that the local self-government would most probably have a deficit slightly lower (and not higher) than planned in view of the fact that in October 2011 became effective the amended Law on Local-Government Financing according to which 80%, instead of 40%, of personal income tax pertains to local-self-government. Because of the amendment of this Law in 2011, revenues of local self-government budgets increased by about 8 billion dinars (by which amount the Republic revenues dropped). However, in parallel with additional revenues the expenditures at local level suddenly increased at the year-end (particularly in December), so that instead of expected savings, the local-government increased the deficit.

The assessment of the Fiscal Council concerning the surplus of social insurance finds is the result of temporary factors, rather than the result of their truly positive operation balance. The provisional surplus arises from the sizable payments of contributions made in the last 2-3 days of 2011 that the funds did not have time to spend. The largest surplus among the obligatory social insurance funds in 2011 was registered in the Republic Health Insurance Fund (RFZO) of 2.1 billion dinars. The Fiscal Council recalls that RFZO has increasing arrears to its suppliers of a range of about 17 billion dinars (about 0.5% of GDP) – or several times higher than the surplus in 2011. It is believed, therefore, that this provisionally realized surplus in the obligatory social insurance funds will soon vanish for the financing for current expenditures or for the financing of the arrears.

The Fiscal Council deems that the overstepping of the 2011 fiscal deficit by about 5 billion dinars is not sizable; however, the trends recorded at the close of the year and the shifting of some obligations to 2012 clearly indicate that it will be hard to achieve the 2012 planned fiscal deficit of 152 billion dinars (4.25% of GDP). In the December 2011 report[2], the Fiscal Council assessed a possible public revenues deficit in 2012 at the level of about 35 billion dinars (1% of GDP) due to the optimistic planning of the GDP growth of 1.5% (the projection is currently lowered to 0.5%), but also the optimistic planning of revenues from the contributions and VAT. Data from December 2011 and January 2012 corroborate this forecast because of which the Fiscal Council believes that it is almost certain that additional budgetary adjustment of about 1% of GDP will be necessary in 2012 so as to enable achievement of the planned fiscal deficit of 4.25% of GDP.

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[2]For more details see: „Evaluation of the Fiscal Strategy Report and Draft 2012 Budget Law" of 23 December 2011, www.fiskalnisavet.rs

Fiscal Rule Concerning General Government Debt in 2011

At the close of December 2011, the public debt was around 46.4% of GDP. According to the data of the Ministry of Finance, the public debt (according to the Public Debt Law) reached 45.1% of GDP at the end of December. According to the Budget System Law, which defines the fiscal rules, the non-guaranteed debt of the local self-government of 1.4% of GDP in December needs to be added to this debt. This leads to the total amount of the public debt of 46.4% of GDP at the close of 2011, which violates the fiscal rule that limits the public debt level at 45% of GDP.

Actual size of the public debt probably exceeds the 46.4% of GDP-a, because the Fiscal Council's analysis has shown the existence of accumulated arrears of some budgetary beneficiaries (RFZO) which exceed the current operation potential for their servicing. As the covering of such arrears will also require a borrowing, the real public debt most probably exceeded 47% of GDP as early as at the close of 2011.[3]

In 2011, the public debt rose by about EUR 2.3 billion, and in GDP percentage the public debt went up by 2.2 percentage points against the 31 December 2010 value. The public debt growth is mostly the consequence of the fiscal deficit financing and also of the increase of government guarantees issued to public enterprises.

The government borrowing in the course of 2011 was somewhat higher than necessary for the financing of its current obligations. Namely, the government increased its deposits with the issue of Eurobonds in the amount of about EUR 700 million (2% of GDP). Formed deposits will be spent for the financing of the government liabilities in 2012. It is worth mentioning that the public debt will continue its growth in 2012 despite the formed deposits, taking into account that the government liabilities in 2012 are considerably larger than the deposits it disposes of.

The Fiscal Council's estimate is that at the close of 2012 the public debt will reach 51% of GDP, on condition that the trends of macroeconomic aggregates and fiscal policy are in conformance with the current plan (deficit of 4.25% of GDP). The public debt growth is inevitable since the growth rate of 2012 GDP (according to the last projections) will be only 0.5%, and since the planned fiscal deficit is 4.25% of GDP. To all this needs to be added the planned issue of guarantees to public enterprises[4], and also the government borrowing „below the line" (recapitalization of Komercijalna banka, etc.). When all of the above is taken into account[5], the Fiscal Council's estimate is that the public debt will be around 51% of GDP at the close of 2012. It is also of essential importance to note that the public debt in 2012 will be considerably above the legal limit of 45% of GDP regardless of the method applied to its calculation[6]. Graph 3 presents the public debt trend against GDP since 2007, and the projection for 2012.

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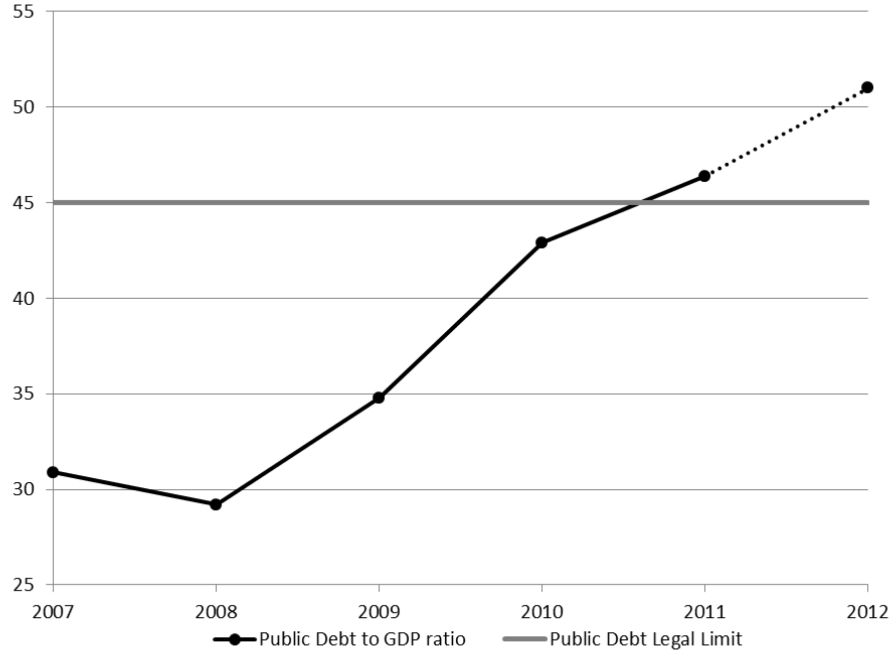
[3] In view of the currently different interpretations in public of the public debt level depending on its capture and calculation methodology (Ministry of Finance, NBS, IMF) the Fiscal Council is preparing a methodological paper „Proposal for Improving the Public Debt Capture and Measurement Methodology" which will include a detailed explanation and a proposal for a standardized methodology for public debt calculation in accordance with recommended international standards.

[4] The Fiscal Council has assumed in its projections that about EUR 300 million of new borrowing guarantees will be issued in 2012, which is compliant with the original agreement with the IMF, or its assumption was that not all EUR 450 million guarantees envisaged by the budget would be withdrawn.

[5] About 1.5% of GDP relating to fiscal deficit from government deposits was taken into account in assessing the public debt trend.

[6] See the Fiscal Council's „Proposal for Improving the Public Debt Capture and Measurement Methodology".

Graph 3. Public Debt to GDP ratio, 2007 - 2012



Note: starting from 2011, the public debt includes the non-guaranteed local self-government debts; relevant data relate to the year-end (dots on the Graph).

There are pronounced risks for the public debt to be at 2012-end significantly higher than the estimated 51% of GDP. The risks can be classified into two groups - one relating to the fiscal policy and those relating to the movement of macroeconomic aggregates. From the angle of economic policy, two basic risks relate to the level of fiscal deficit and the value of government guarantees issued in 2012. Namely, if measures are taken which will keep the general government deficit at 4.25% of GDP, potential increase of the fiscal deficit would additionally augment the public debt (The Fiscal Council has already perceived a potential gap in the budget of about 1% of GDP, which can augment the deficit to 5.25% of GDP). Also, the issuance of an amount of new borrowing guarantees larger than announced (the reason for the delay of the first review of the arrangement with the IMF) increases the public debt. When macroeconomic risks are concerned, the most important are the exchange rate of the dinar and the speed of economic activity growth. As the bulk of the public debt is denominated in the EUR, a possible depreciation of the dinar against the EUR would contribute to increased share of the public debt in GDP. Also, in the case of stagnation or even drop of GDP in 2012, the debt share in GDP will automatically rise. Accordingly, the Fiscal Council's estimate of the public debt level at the end of 2012 of about 51% of GDP is mildly optimistic. If the mentioned risks materialize, the public debt could easily reach 55% of GDP at the close of 2012.

The Fiscal Council's analysis indicates that in the absence of a fiscal consolidation program the public debt will also continue to rise in the medium term. Under the optimistic assumption that a steady recovery of the economy will start from 2013 – if real GDP growth were 3% in 2013 and 4% in 2014, the fiscal rules would envisage the lowering of the government deficit to 3.7% of GDP in 2013 and to 2.9% of GDP in 2014. In spite of the lowering of the deficit, the public debt would continue to rise, though – and would reach the level of about 55% of GDP – which would then mean that with the obligations for the restitution, the public debt of Serbia would in 2015 probably exceed even the Maastricht criterion of 60% of GDP. This explains the Fiscal Council's assessment that the overstepping of the public debt limit of 45% of GDP at the end of 2011 is of a lasting rather than temporary nature, and that it is necessary that the Government prepare a program for the public debt reduction.

According to the Budget System Law (Article 27e), if the public debt exceeds 45% of GDP the Government has a duty to submit to the National Assembly, along with the budget for next year a program for the debt decrease against GDP. The interpretation of this legal provision by the Fiscal Council (which is economically necessary) is the adoption of the program for public debt reduction as early as at the time of the 2012 Republic budget revision.

The public debt growth significantly above the level defined by fiscal rules is inevitable. Therefore, its return to the legal framework limit of 45% of GDP, even with an ambitious program for public debt reduction, will most probably not be possible before 2016. It is necessary, however, to take measures in the meantime to help to significantly slow down and then also halt the public debt increasing trend. Namely, economically viewed, a danger even graver than violation of the legal regulations is the worrisome trend of the fast public debt growth in the previous years – only in three preceding years it rose by EUR 5.7 billion, and its share in GDP went up from 29% to 46% (Graph 3). If this trend is not reversed in the short run, there is a danger that investors will very quickly lose confidence in the sustainability of the public finance in Serbia.

Belgrade, 20 February 2012