Republic of Serbia
Fiscal Council

EVALUATION OF THE FISCAL STRATEGY REPORT AND DRAFT 2012 BUDGET LAW

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Introduction

The Fiscal Council is an independent government agency accountable to the National Assembly of Serbia. According to Article 92ž of the Budget System Law, the task of the Fiscal Council is to prepare an analysis of the revised Fiscal Strategy Report and of the Draft Law on the Republic of Serbia Budget and submit it to the National Assembly of Serbia.

In accordance with the legal obligation, the Fiscal Council has analyzed the Report on Fiscal Strategy and the Draft Law on 2012 Republic of Serbia Budget and, as set out in Article 92ž of the Budget System Law, is submitting the evaluation of the mentioned documents to the National Assembly.

BASIC EVALUATIONS

The Fiscal Council is evaluating the fiscal policy planned to be pursued by the Government in 2012 as well as the guidelines and projections for 2013 and 2014. The Government of the Republic of Serbia has proposed to the National Assembly the adoption of the Law on the Republic of Serbia 2012 Budget (republic budget) and the revised Report on Fiscal Strategy for 2012 with the projections for 2013 and 2014. According to the Budget System Law (Article 92ž), the Fiscal Council presents a combined opinion about these two documents. The basic fiscal and macroeconomic framework for 2012, agreed upon by the Government and the IMF, involves reduced estimate for the real GDP growth in 2012 to 1.5% and consolidated deficit of general government of 4.25% of GDP.

The envisaged fiscal deficit of 4.25% of GDP (153 billion dinars) is in conformance with the fiscal rules; there are, however, pronounced risks of the planned deficit overshooting. According to fiscal rules, lower economic growth leads to increased fiscal deficit of the consolidated government. Basically, due to the slowdown of economic activities tax revenues fall. Therefore, in line with fiscal rules, and also in the spirit of a good economic policy, it is justified to allow a somewhat larger fiscal deficit. With the real growth of GDP of 1.5%, the largest deficit of consolidated government in 2012 of 4.5 of GDP was determined by the fiscal rules. However, the Fiscal Council's estimate is that the public debt in 2012 will be above the legally defined limit of 45% of GDP and as such will violate the fiscal rule relating to pubic debt. It was for this reason that the Fiscal Council proposed to the Government that consolidated deficit of the general government in 2012 be smaller that the permitted 4.5% of GDP. The Government consented to the deficit of 4.25% of GDP, and the fiscal rules relating to the general government's consolidated debt are observed. The real fiscal deficit in 2012 could be higher than planned as there is a great probability for revenues to be smaller and expenditures larger than planned.

The fiscal rule on pension and wage indexation in the public sector has been complied with, and appropriate growth of investments has been planned. Pensions and wages in the public sector will be raised on two occasions in 2012 in accordance with the fiscal rules from the Budget System Law. The first increase has been planned for April – at the level of the realized inflation in the period between October 2011 and March 2012 plus one-half of the achieved GDP growth in 2011. The second increase has been planned for October – by the inflation level in the April-September 2012 period. Still, due to the announced employment in the public sector and indirect wage increase in some public services, the costs of labor may be rising faster than the plan. The Fiscal Council evaluates as good news the planned change in the structure of public expenditures in 2012 in which the share of public investments is rising. According to the plan, the share of public investments in GDP is to reach 4% of GDP in 2012, which is approximately equal to the fiscal deficit. In this way has been accomplished to have almost balanced current revenues and current expenditures in 2012, and to have the entire general government consolidated deficit spent on investments.

The Fiscal Council's assessment is that at the close of 2011 the public debt will most probably be above the legal limit of 45% of GDP. At the end of November, the public debt reached 44.8% of GDP, measured in accordance with the Public Debt Law. To this value needs to be added, according to the Budget System Law, the non-guaranteed debt of the local governments for which the official data are published with a lag of several months. According to the latest data available (for September), non-guaranteed debt of local governments is around 1.2% of GDP. Additionally, a part of late repayments of the obligations (arrears) of different government levels, estimated to be around 0.5% of GDP, needs also to be included in the public debt. That is why the Fiscal Council assesses that at the end of 2011 the public debt will exceed 46% of GDP, or will be above the limit of 45% of GDP set out by the fiscal rules. Definite evaluation with respect to the compliance with the fiscal rule relating to public debt (but also to fiscal deficit in 2011) will be made public by the Fiscal Council in February 2012 when the official data for the whole year will be available.

The Fiscal Council's assessment is that due to the low growth of economic activity the public debt in 2012 will be above 45% of GDP. In 2012, due to slowed down growth of economic activity, with the planned deficit of 4.25% of GDP and increase in issued government guarantees, the public debt will probably continue to grow. As the Fiscal Council assesses that the public debt will at the close of 2011 already be above the legal limit of 45% of GDP, it is almost certain that it will remain above this limit in 2012. Once it is officially confirmed that the fiscal rule relating to public debt is violated, the Government's obligation will be to prepare a credible plan of measures the adoption of which will have first to halt the growth of the public debt and then, over a medium term, the return the public debt to the level below 45% of GDP on a lasting basis.

There are serious risks of non-materialization of the planned fiscal policy in 2012. The Fiscal Council has identified and analyzed three basic risks on the way of implementation of the planned fiscal policy in the next year: 1) *smaller than planned growth of economic activity*; 2) *larger fiscal deficit* – principally as a consequence of optimistically planned public revenues, but also of the likelihood of expenditures being larger than the plan, and 3) *the risk of financing* of the deficit and repayment of the public debt principal.

There are strong prospects for the real growth of GDP to be lower in the next year than the planned 1.5%. Unfavorable economic trends in the Euro zone countries with which the domestic economy is strongly tied can easily take Serbia to a prolonged stagnation or even a new recession. In 2012, the Fiscal Council expects the braking of exports and stoppage in investment activity, which is linked to the negative developments in the Euro zone, while contribution of public and personal consumption to the economic growth is limited by their slow growth (see Section 2: „Economic Activity and Budget Deficit in 2012“). That is why the Fiscal Council does not exclude the possibility of stagnation in 2012 (GDP growth of 0%) instead of the planned real GDP growth of 1.5%.

Possibly lower than planned economic growth would have a negative impact on the public debt and fiscal deficit. If in 2012 the real GDP growth is 0% rather than the planned 1.5% that would have a direct impact on the growth of the public debt's share in GDP by about 0.7 percentage points (p.p.) of GDP. Because, when GDP is falling the share of the debt in GDP is consequently rising. Also, the economic growth below the planned 1.5% would lead to a decrease in public revenues by about 0.6% of GDP. Although, according to the fiscal rule relating to deficit, the slowdown of economic growth would need to contribute to the rise of fiscal deficit, the Fiscal Council estimates that that growth of general government's deficit in 2012 in excess of the planned 153 billion dinars would be unsustainable and, accordingly, unacceptable. Additional increase of the fiscal deficit would not be useful for the economy, either, because multiplicative effects of fiscal simulations in Serbia are modest, and in the case of a public debt crisis the recession in the economy would be certain.

The Fiscal Council's analysis points to a possible overestimation of public revenues in 2012 even at the planned GDP growth of 1.5%. In view of the Fiscal Council, the growth of revenues from VAT and contributions in 2012 was in the Report on Fiscal Strategy and in the Republic Budget Law too optimistically planned (see Section 3: „Projection of Public Revenues in 2012“). The planned growth of revenues from VAT is not consistent with estimated trends of personal consumption which is the tax base for VAT. It is for this reason believed that instead of the planned increase in the share of VAT based revenues in GDP by 0.1 p.p, more probable is the drop in their share in GDP by 0.1 p.p or it is believed that in the Report on Fiscal Strategy and in the Draft Budget Law the planned revenues from VAT were overestimated by about 0.2% of GDP (about 7 billion dinars). For the second key component of tax revenues – contributions – a real growth of about 3% was planed in 2012. The drop in employment in 2011 indicates that the share of contributions in GDP, even in the case of improved rate of collection, will remain unchanged, i.e. planned growth of the share of revenues based on contributions at the level of 0.2 p.p. will not materialize. Therefore, the Fiscal Council's assessment is that revenues from contributions have been overestimated for the next year by about 0.2 p.p. of GDP. Taking into account all of the above facts, the Fiscal Council estimates that the planned tax revenues in 2012 are by between 0.4 and 0.5% of GDP (or by between 15 to 18 billion dinars) larger than it is feasible to be achieved with the real GDP growth of 1.5%.

The Fiscal Council believes as quite likely that total shortfall of public revenues in 2012 could be about 1% of GDP (35 billion dinars) relative to the plan. The above analysis indicates that tax revenues were probably initially overestimated by between 0.4 and 0.5% of GDP. If GDP growth in 2012 is 0% instead of the planned 1.5%, which is fully possible, it will contribute to additional decrease of tax revenues by about 0.6% of GDP. Indeed, the Fiscal Council deems possible for fiscal revenues to be smaller in 2012 by about 1% of GDP or by about 35 billion dinars than planned by the Report on Fiscal Strategy and the budget framework for 2012. If adequate measures are not taken to make up for this loss, the result would be unsustainable increase of the fiscal deficit in 2012 - from 4.25% of GDP to about 5.3% of GDP.

Total financial assets necessary to finance the government liabilities in 2012 are large – they amount to about 510 billion dinars (152 billion for the deficit and 360 for repayment of the public debt principal). It is possible to finance a part of liabilities of around 50-60 billion dinars from the existing foreign exchange government deposits which at the end of the year are over EUR 900 million. Accordingly, it will be necessary to provide 450-460 billion dinars for the financing of the fiscal deficit and the principal due in 2012. The largest part of these assets could be provided by the refinancing of due short-term debts based on securities in the amount of 230 billion dinars. The remaining assets needed to finance the fiscal deficit and due debts are equal to 220-230 billion dinars. It has been planned that these assets be partly provided by withdrawal of the tranches of the already contracted credits (credits for infrastructure), while the remaining part will be provided by new borrowing on the domestic and foreign markets (see Section 6: „Consolidated Deficit and Financing“). When to all this is added the planned additional government borrowing for regulation of the debt of obligatory social insurance organizations, preservation of financial stability, for urgent interventions from commodity reserves and for recapitalization of Komercijalna banka (which will, perhaps, be paid from the government deposits) in a total amount of more than 65 billion dinars (which are posted „below the line“), one can more clearly see the serious risk in terms that the government needs for financial assets in 2012 may exceed the borrowing ability.

In 2012, problems may emerge with regard to the financing of government liabilities. 1) Refinancing of about 230 billion dinars of treasury bills which fall due for collection in 2012 may account for a serious short-term risk. The latest relevant international analyses point to likelihood of a start of capital withdrawal from the Central and Eastern European countries by banks due to the lack of liquidity, which could cause their exit from the treasury bills and give rise to difficulties in the deficit financing and repayment of the public debt in Serbia. 2) The needs for financing in the next year suppose, however, not only the refinancing of the existing assets on the domestic financial market, but also the provision of addition al funds – estimated by the Fiscal Council to be at the level of about 100 billion dinars. Therefore, it is not unlikely that the domestic financial system may not be able to finance such government needs in the next year. Moreover, such government borrowing may lead to ousting of private investments. 3) The financing of the remaining resources with foreign creditors inevitably requires trust on the part of investors in the credit worthiness of the debtor, in this case the credit worthiness of the state of Serbia. The public debt crisis in the Euro zone additionally erodes the trust of investors so that borrowing terms and conditions are worsening. Although the data are not fully comparable, the government borrowed on the market at the rate of interest of about 6% (in Euros) in the course of 2010, in 2011 investors were already demanding the interest rate of 7.25%, and it is quite likely for this trend to also continue in 2012. Therefore, each new borrowing on the market will be even more difficult and more expensive than in 2011.

The Fiscal Council believes that the Government needs to immediately start preparing itself for a possible deterioration of the fiscal flows in the next year. Its analyses show that possible difficulties in current financing of the government liabilities may arise as early as in the first half of next year, for which the current government must have prepared measures in place. Also, the Government must have the responses in place to the observed risks of lower than planned public revenues. If it is established in 2012 that the drop of public revenues is moderate relative to the plan (up to 0.5% of GDP), the room for corresponding savings is seen in those segments of the public sector the expenditures of which are rising in 2012 disproportionately higher than in others – local governments and budgetary beneficiaries with their own revenues. If the drop of public revenues relative to the fiscal framework planned for 2012 is larger or about 1% of GDP, the mentioned savings will not be sufficient. The assumption of a drop in public revenues of about 1% of GDP is not impossible as it corresponds to the economic growth of 0% in 2012 instead of estimated 1.5% (smaller public revenues by about 0.6% of GDP due to the stagnation of economic activity and by 0.4-0.5% of GDP due to the initial optimistic planning of public revenues). Fiscal adjustment to such a loss of public revenues cannot be painless. The solution over a short term can be between a sharp reduction of public investments, reduction of current public expenditures (of the order of magnitude of pension and wage freeze), increase of public revenues, or a combination of several measures.

The amended Law on Local Self-Government Financing resulted in major disbalances of revenues and expenditures at different government levels. The republic level loses about 40 billion dinars (1.1% of GDP) in 2012, which is the net effect of the implementation of the Law on Local Self-Government Financing. Revenues of the local government level increase by the same amount. In order to make up for the loss on this ground, the republic budget has been forcedly reduced on the positions of discretionary spending (see Section 5: „Fiscal Framework for Individual Government Levels“). Expenditures for the purchase of goods and services, subsidies and net budgetary lending in 2012 were nominally reduced by as much as 25 billion dinars relative to 2011. Additional 15 billion dinars in the republic budget has been planned to be provided from one-off revenues from the companies in bankruptcy – from bankrupt estates will be collected the outstanding government’s receivables. The Fiscal Council has certain reservations with regard to planned major cuts of the republic budget although it basically supports the reduction of current public expenditures. Namely, according to the Fiscal Council, the envisaged savings will most probably not be sustainable and their consequence will be increased delays in the payment of obligations. Also, revenues from the bankruptcy of companies, even if achieved in the planned amount during the next year, cannot be counted with on a lasting basis. Therefore, measures that would systematically resolve the newly-emerged problem of smaller revenues of the Republic need to be undertaken.

On the other hand, the local government level is strongly increasing its discretionary spending. Due to decentralization, the local self-government receives additional 40 billion dinars in 2012. At the same time, obligations from the expenditure side of the budget are increasing at the local government level by about 15 billion dinars. Namely, this is the amount that the local self-government takes over on the grounds of maintenance of local roads that were earlier within the competence of the public enterprise JP „Putevi Srbije" (around 10 billion dinars) and local investment projects earlier implemented by the former Ministry for NIP (about 5 billion dinars). The remaining 25 billion dinars will be mainly spent by the local government level on the rise of subsidies, capital investments and purchase of goods and services – the items that the republic budget deprives itself of in the next year.

The Fiscal Council's view is that the increases of local self-government revenues have to be accompanied by a shift of a larger number of competences from the central to local government level. The insufficiently well prepared fiscal decentralization is threatening to endanger the discharge of some of the basic functions of the Republic budget and social insurance funds. The risk additionally rises with a possible deterioration of fiscal flows in 2012. As there is no room for additional increase of deficit and additional borrowing in 2012, a good measure for revenues adjustment is a shift of a certain portion of competences from the central to the local government level. The Fiscal Council believes that the local self-government needs to use the additional assets it will receive in 2012 for payment, in the first half of the year (directly or through local public enterprises), of the accumulated arrears, which would at the same time have a desirable anti-recessionary effect on the economy. In the second half of the year, the new government will have to take measures as early as possible for shifting a part of competences from the central government level, probably from the domain of social welfare (material assistance to families, parents allowance, etc.). The basic idea of the proposed shift is to fully avail of the existing administration, and the local government participation in the financing of social purpose allocations for the beneficiaries in its territory. In this way, the efficiency of the state administration would not be lowered while non-productive increase of local administration employees would also be prevented.

Additional savings in 2012 can also be ensured by smaller spending of budgetary beneficiaries' own revenues. While the republic budget (according to narrower definition) is decreasing the deficit and planning sharp cuts in spending, the use of budgetary beneficiaries' own revenues in 2012 is simultaneously rising by 20%-25% in real terms (according to the methodology used in the Report on Fiscal Strategy). By the revised 2011 budget were planned – perhaps not to materialize in full – the savings of own revenues of some budgetary beneficiaries in 2011 (Environment Protection Fund, Budget Water Fund of the Republic of Serbia, Treasury Administration and the Ministry of Justice) in a total amount of 9 billion dinars. However, such savings from own revenues are not planned in 2012. It principally means that some government funds attached to the Ministry of Agriculture and Ministry of Environment Protection and Spatial Planning will significantly increase their expenditures in the next year. The Fiscal Council is of the view that it is necessary to consider a possibility of certain savings of own revenues in 2012, too. Also, it considers that joining of certain funds with competent ministries would be necessary as their operation and revenues that are generated would be brought under the strong budgetary control.

The Republic Health Insurance Fund (RHIF) is accumulating large arrears in the payment of its obligations which can transform into a public debt. According to the latest data available to the Fiscal Council, RHIF arrears are about 0.5% of GDP (about 17 billion dinars). Of particular concern is the trend of their permanent rise. As the arrears exceed 10% of annual RHIF expenditures (which are mostly pre-defined – doctors' wages and purchase of medicaments), the Fiscal Council believes that this problem cannot be solved without an active role of the Government. A solution to RHIF arrears issue would in such a case be sought in a possible agreement with suppliers on the debt rescheduling with a probable credit borrowing from the government. It is therefore believed that RHIF arrears are a potential public debt which will raise the current public debt level by additional 0.5% of GDP. Also, it is necessary to improve on a lasting basis the funding mechanisms and the procedures for procurement of drugs in order to achieve the RHIF revenues and expenditures adjustment, and prevent new debts.

In the medium run, lasting sustainability of public finance requires fiscal adjustment by 4.5 to 5 p.p. of GDP. The Fiscal Council analyzed the fiscal adjustment that would allow in the medium run (about 5 years) reach from the deficit of 4.25% of GDP in 2012 to the target deficit of 1% of GDP. Starting from its own projections of public revenues (which are lower than the projections from the Report on Fiscal Strategy by 0.6 to 0.7% of GDP), the need for public investments share to be raised by about 0.7% of GDP (from planned 3.8% of GDP to 4.5% of GDP), and the lowering of the deficit by 3.25% of GDP – the Fiscal Council got the estimate of the needed medium-term fiscal adjustment (decrease of expenditures and possible increase of revenues) by 4.5 to 5% of GDP. Such a large adjustment is feasible only with the substantial reforms of public finances.

The Fiscal Council believes that the majority of the fiscal adjustment should be achieved through the decrease of current public expenditures. Estimated share of public expenditures in GDP of about 44.2% of GDP in 2012, of which more than 40% of GDP are current public expenditures, is too high. It is, therefore, believed that the key strategic determination of the government needs to be the lasting lowering of current public expenditures share in GDP, and that possible increase of public revenues needs to be of secondary importance. The period in which current expenditures need to be lowered is an additional limitation since the Fiscal Council's estimates point to unsustainable public debt growth in the absence of early commencement of fiscal adjustment (see Section 7: „Fiscal Framework for 2013 and 2014").

The Fiscal Council's opinion is that a comprehensive plan of the public sector reforms needs to be prepared in 2012 and that legal regulations need to be changed in accordance with such plan. As more than 70% of expenditures is determined by the law and obligations (like payment of interest on the public debt), the Government's maneuvering space for possible savings is small in the short run. However, if preparation of credible reforms starts right away and if the existing laws are amended on that basis in the next year, it is possible to improve efficiency of the public sector in the medium term and adjust the overall public consumption to the economic possibilities of the country.

Timely systemic decrease of public consumption against GDP would crucially contribute to the prevention of debt crisis. Sufficient savings on the position of current expenditures can only be achieved by systemic structural reforms targeted to the largest expenditure items of the budget: reform of the health and education sectors, rationalization of the public administration, establishment of a sustainable fiscal decentralization system, rationalization of public enterprises, and continuation of the pension reform.

A comprehensive tax reform will probably also be necessary which will, apart from improving the economic ambiance also have a net positive effect of public revenues. Over the past couple of years, the share of public revenues in GDP has dropped despite the fact that the most important tax rates remained unchanged. This drop can be explained by the change in the structure of the economy on account of decrease in consumption. Taking into account that similar trends will probably continue in the future as well, the Fiscal Council deems it necessary to launch a comprehensive tax reform that will by total effects result in a certain increase of public revenues. Within such reform would increase the revenues based on VAT, property tax and profit tax, while fiscal burden on labor would decrease and numerous quasi fiscal imposts would be lowered/abolished. The listed changes would apart from the desirable fiscal implications also have a significant positive impact on the improvement of business ambiance.

Evaluation of the Draft Law on the Republic of Serbia 2012 Budget

The Republic budget has been prepared in accordance with fiscal rules, but there are strong risks of non-materialization of the plans. The deficit of the republic budget, or the budget revenues and expenditures are projected in conformance with the fiscal framework for 2012. The deficit of the republic budget is 140 billion dinars, or somewhat higher than 3.9% of GDP. Taking into account the planned deficit of the local government level and the negative financial result of JP „Putevi Srbije“, which combined amount to around 0.3% of GDP, one gets the total deficit of consolidated government of 4.25% of GDP. Therefore, the Fiscal Council evaluates that the Law on the Republic of Serbia budget is harmonized with the fiscal rule relating to consolidated government deficit. The republic budget deficit of 140 billion dinars is in nominal terms identical to the deficit in 2011; however, due to the impact of inflation, it has been reduced by about four percent in real terms.

It is most probable that the republic budget revenues were initially overestimated to some extent. The view of the Fiscal Council is that VAT based revenues were overestimated by about 0.2% of GDP, because the estimates of real growth of VAT based revenues of 1.5% from the Budget Law are not in accordance with the estimated lower personal consumption trends in 2012, which is the tax base for VAT. Revenues from corporate profit tax will probably be somewhat lower than planned because of the deterioration in the economy caused by the stagnation in the last three quarters of 2011. Also, non-tax revenues will in the next year largely depend on the recovery of the claims against companies in bankruptcy and dividends from the realized revenues of public enterprises, which may still be uncertain. It is therefore possible that the republic budget revenues will be by about 10 billion dinars smaller against the plan from the Budget System Law.

Significant reduction of expenditures for the purchase of goods and services, subsidies and net budgetary lending – is the consequence of the fact that the bulk of the Republic budget expenditures is pre-defined by the legal regulations of the state and the obligation under public debt repayment. The government's obligations under the payment of wages to the public sector employees are rising by about 15 billion dinars because in 2012 the wages will be indexed in accordance with the Budget System Law. There has also been observed a considerable rise in allocations for the transfers to the Pension and Disability (PIO) Fund (about 15 billion dinars), taking into account that the costs of pension payments are rising faster than the growth of contributions earned by this fund. The third large pre-defined expenditure item relates to allocations for interest payments which are rising in real terms by as much as one-third against 2011 (around 20 billion dinars). This was the reason for the forcibly made serious cuts in the Republic budget for the purchase of goods and services, subsidies and net budgetary lending. The decrease of the listed items is desirable but as things stand it was not done in a systematically long-term sustainable manner.

The Fiscal Council assesses that there are strong risks of non-materialization of a part of savings in the Republic budget, and that transfers to the PIO Fund may be larger than planned. The sharp decrease of discretionary spending (purchase of goods and services, subsidies and net budgetary lending), as planned, will be hard to be achieved in 2012 and may ultimately lead to a dangerous postponement in the meeting of obligations (arrears) by the Republic or to a possible increase of these items on the occasion of the budget revision. Illustrative is the fact that expenditures for the purchase of goods and services, subsidies and net budgetary lending (after adjustment for the subsidies for JP „Putevi Srbije" because of the takeover of the revenues under excise duty) are insignificantly larger in nominal terms than five years ago (in 2007). The Fiscal Council has taken the year 2007 as suitable for comparison because in that year there were neither anti-crisis measures nor liabilities for the government's obligation to make allocations for the investment with the Italian company FIAT. It means that the expenditures on the observed budget items are in real terms smaller by more than 25% relative to typical allocations for these purposes. In addition to all of that, there are also certain risks of even larger republic budget obligations as it is possible that the collection of contributions in 2012 could be smaller than planned, which would then be compensated by larger transfers to the PIO Fund from the republic budget.

Imprecise and insufficiently transparent planning of the spending of own revenues can endanger achievement of the fiscal targets in 2012. A large portion of the public administration: ministries, funds, directorates, institutions, etc. generate their own revenues from different fees, duties, fines, while some pubic administration units even manage project loans. The analysis made by the Fiscal Council has identified that the manner in which these assets are used, as well as their presentation in the Budget Law, are not in accordance with the best practice of public finance management and that can endanger the achievement of the fiscal objectives set in 2012.

1) **Unreliable budgeting of own revenues can increase the deficit of the Republic.** Plans of own revenues spending (middle column in detailed tables of the republic budget) are by far larger than those presented in aggregate tables of revenues and expenditures of the Republic budget (Article 1 of the Budget System Law) and, accordingly, do not limit sufficiently the spending of own revenues. As there is about 15 billion dinars of accumulated budgetary beneficiaries' own revenues from previous years, they can be used, due to the lack of budgetary control, for increase of public consumption and of the Republic deficit.

2) **Limitation in the budget planning are circumvented through own revenues.** In 2012, an unusually high growth of expenditures from budgetary beneficiaries' own sources is planned after the sharp cut of expenditures from budgetary assets. The Fiscal Council has identified that some essential government economic functions, such as subsidies, are shifted to the financing from own sources – where the control of their spending is weaker. Thus, in the Ministry of Agriculture was identified an exceptionally high growth of subsidies against 2011 which has been planned to be paid through the Budget Water Fund of the Republic of Serbia, Directorate for Agricultural Land and Budget Forest Fund of the Republic of Serbia – from 5 to 15 billion dinars.[1] By all indications, through these Funds is also paid temporary employment of a large number of experts in the field of agronomy and forestry – being in this manner circumvented the fiscal rules the objective of which is to reduce the allocations for wages relative to GDP.

3) **Unforeseeable utilization of project loans is an additional risk on the way to achieving the targeted budget deficit.** In the Budget Law (Article 1), project loans were omitted due to which the presented deficit of the Republic is only 125 billion dinars. Project loans in 2012 are estimated at 15.5 billion dinars and only by taking them into account one gets the real deficit of the Republic which is 140 billion dinars. However, if more than planned projects are drawn down, the deficit will be higher than envisaged by the plan. Two facts are worth mentioning: a) in 2011, at the beginning of the year, the number of project loans that were drawn down was larger than planned for that part of the year so that dissention from the plan of project loan drawdown is not an unusual practice, and b) in the detailed budget tables (Article 7 of the Budget Law) draw-down of significant assets was planned under project loans (about 30 billion dinars) which is a significantly larger amount relative to the estimate used when preparing the budget (15.5 billion dinars). That is why no legal limitation is in place that would prevent the use of project loans from exceeding the plan and, consequently, increase of the Republic deficit.

Adoption of certain Laws, like Amendment of the Law on Police, can be a dangerous precedent by which fiscal rules are circumvented. By the amendments of the Law on Police were raised the allowances for police officers. On this basis, additional 3.6 billion dinars will be allocated in 2012 for wages in the Ministry of Interior, when compared with 2011. Legal indexation of wages in the public sector is defined by the Budget System Law and represents (along with pensions) the basic anchor for curbing the growth of public expenditures. For this reason, adoption of individual laws similar to this one can disrupt the fundaments of the public expenditures policy in Serbia. There is no economic

[1] It is impossible to foresee exactly how large will be the growth of allocations for subsidies from own revenues due to the systemically overdimensioned budgeted spending of own revenues.

justification for the wage increase in the public sector, not only because of the high deficit and the risks faced by the fiscal policy, but because the relevant studies (The World Bank and others) show that there is a surplus of employees in the public sector and also that the wage level and employment security are better in the public than in private sector.

New guarantees planned for the borrowing of public enterprises, along with the growth of direct government borrowing, are not in conformance with the need of curbing the public debt growth. In the Draft 2012 Budget Law are planned the guarantees to commercial banks for the borrowing of the public enterprise „Srbijagas" which is almost 70 billion dinars, of which amount 40 billion dinars is the borrowing for current liquidity. The Fiscal Council points out that issuance of such guarantees, apart from leading to undesired and highly dangerous public debt increase would also be contrary to the performance criteria of the current arrangement with the IMF. The Government also plans additional direct borrowings like the one for urgent interventions from commodity reserves in the amount of 10.5 billion dinars, and 45 billion dinars for regulation of the debt of the obligatory social insurance organizations and preservation of the financial stability, which additionally confirms the Fiscal Council's previously presented view that a part of the arrears need to be included in the public debt. Namely, a part of this credit will be most certainly used for repayment of the arrears accumulated by the obligatory social insurance funds over the previous years.

EVALUATION OF THE REPORT ON FISCAL STRATEGY AND THE DRAFT LAW ON 2012 BUDGET

1. COMPLIANCE WITH FISCAL RULES IN 2011

The Fiscal Council expects the fiscal rule for the deficit level to be complied with in 2011. Starting from the deficit recorded in 2010 (4.6% of GDP) and the expected rate of economic growth in 2011 (2%), the Budget System Law requires that the deficit of general government sector in 2011 is 4.5% of GDP or 153 billions dinars. At the same time, the deficit of the Republic of Serbia budget (without own budgetary beneficiaries ' revenues) has been planned in the amount of 142.7 billion dinars, and the deficit of the Republic budget together with own revenues of the budgetary beneficiaries has been planned at the level of 134 billion dinars. Total deficit of general government in the January-October period was 118 billion dinars, while the deficit of the republic budget (without own revenues) was 123 billion dinars in the January-November period or 120 billion dinars if expenditures financed by own budgetary beneficiaries' revenues are taken into account. In view of the public finance trends in the first ten months of 2011, the Fiscal Council expects the public revenues and expenditures realization by the end of 2011 to be compliant with the fiscal rule for the deficit level.

Changes have occurred in the savings per different budgetary beneficiaries relative to the September plan. At the level of the Republic (according to narrower definition), savings will materialize or the republic budget will have a deficit smaller by 5 to 10 billion dinars than the one planned by the budget revision. On the other hand, budget beneficiaries generating own revenues will not fully achieve the planned savings of 9 billion dinars, and it was also noted that realization of project loans, which are also registered beyond the narrower definition of the Republic, is somewhat faster relative to the September plan – which also contributes to the rise of fiscal deficit. Total effect of the savings of budget beneficiaries generating own revenues and of the acceleration of the project loans realization leads to a decrease in planned savings by about 5 billion dinars. Taking into account that at the level of the Republic (according to narrower definition) the savings will be larger than planned by approximately the same amount, the Fiscal Council's assessment is that the overall effect of larger savings of the Republic by narrower definition and smaller savings from own revenues and project loans will be neutral on the planned consolidated deficit. The Fiscal Council assesses that the deficit of municipalities, towns and the Autonomous Province of Vojvodina will be in accordance with the planned fiscal framework from September. Such conclusion results from observing the realization of the local self-government budget until October, when the deficit was about 7 billion dinars. As the local government level is receiving more assets starting from October based on the amendments of the Law on Local Self-Government Financing, the Fiscal Council expects the deficit at the local self-government level to be somewhat lower in the last two months. For this reason, the targeted local self-government deficit will most probably be achieved. Taking into account all of the above, the Fiscal Council believes that the fiscal deficit of 4.5% of GDP will be accomplished thanks to the decrease of the republic budget deficit, which has allowed somewhat larger expenditures from own budget beneficiaries' revenues and a larger utilization of project loans.

The Fiscal Council expects pubic revenues in 2011 to be by six to seven billion smaller than planned at the time of adoption of revised republic budget. At the time of analyzing the draft revision of the 2011 republic budget, the Fiscal Council warned about the pronounced risks of smaller tax revenues by 5 to 10 billion dinars than planned. It seems that these risks have largely materialized so that the Fiscal Council expects public revenues to be at the close of 2011 by about six billion dinars below their originally planned level – primarily due to the gap in expected revenues from excise duties. It is possible that a part of this gap will by the end of the year (during November and December) be compensated by the growth of non-tax revenues.

Over the last two months, realization of public expenditures manifests a slow-down of certain categories of discretionary spending, the objective of which is to annul the earlier mentioned gap of planned public revenues. Slower realization of public expenditures during September and October is noticeable on the expenditure items for subsidies. Also, current trends are also pointing to probable savings on expenditures under repayment of interest and purchase of goods and services. The Fiscal Council expects the savings on these items to be most probably sufficient to annul the expected gap in revenues of about six billion dinars and thus comply with the fiscal rule concerning the deficit amount. The Fiscal Council will make definite evaluation concerning compliance with the fiscal rule for the deficit level during February 2012 – when all relevant final fiscal data for 2011 will be available.

The Fiscal Council expects the limit of the public debt, by the public debt capture as defined in the Budget Law System, to exceed the limit of 45% of GDP at the close of 2011. The Fiscal Council expects the public debt to be between 44% and 45% of GDP according to the capture defined in the Public Debt Law. In view of the fact that the public debt capture defined by the Budget System Law is broader and that it also includes the debt of local self-governments estimated at about 1% of GDP – the Fiscal Council's expectation is that the public debt, according to the definition in the Budget System Law, will be between 45% and 46% at the end of 2011. It is noteworthy that the public debt of the Republic of Serbia is differently defined in the Public Debt Law and the Budget System Law. Either of these definitions is not, at the same time, in conformance with the European standards for public debt monitoring as defined by the Maastricht Rules. Therefore, the Fiscal Council will issue in February 2012, once final data about the 2011 public debt are available, not only the final evaluation of the compliance with the fiscal rule concerning the public debt, but also a methodological instruction for adequate public debt monitoring in the forthcoming period.

The Fiscal Council assesses that the fiscal rules defining indexation of pension and public sector wages are complied with in 2011. The Fiscal Council emphasizes that the consistent implementation of the fiscal rules for wage and pension indexation in the years to come is of key importance for establishment of the fiscal balance and, viewed more broadly, for the sustainability of the economic system of Serbia. Current wage and pension share in GDP as well as the large difference between wages in the public and private sector cannot be economically sustainable in a longer run.

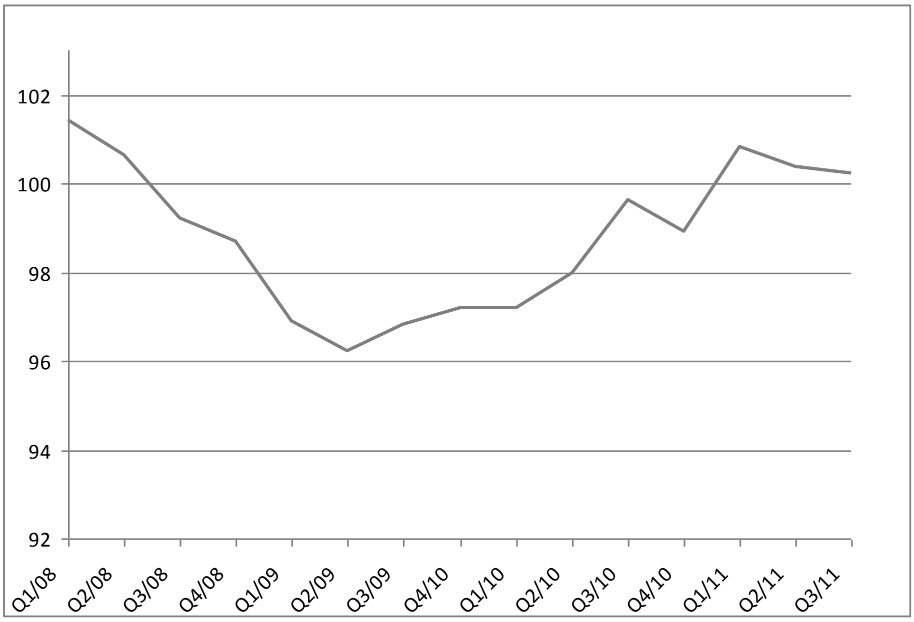
2. ECONOMIC ACTIVITY AND BUDGET DEFICIT IN 2012

The Fiscal Council's analysis indicates that estimated real growth of GDP of 1.5% is achievable in 2012, but that the economic growth is also threatened by serious risks of being even lower. In mid November, estimate of real GDP growth in 2012 was reduced from 3% to 1.5%. Estimated growth was reduced due to the prolonged stagnation of the domestic and European economy. The Fiscal Council holds that the reduction of 2012 growth forecast is justified. It also holds that a possible further escalation of the crisis in the Euro zone would have a negative impact on the Serbian economy and prolong its stagnation throughout the next year or would even take it to a new recession. It is advisable, therefore, to immediately commence considering an adequate fiscal and overall economic policy, if the growth of the economy is smaller than the one currently estimated.

Planned consolidated deficit of general government of 4.25% of GDP in 2012 is in accordance with fiscal rules. The consequence of the lower GDP growth is a smaller amount of revenues which, in circumstances of unchanged expenditures, leads to the growth of fiscal deficit. According to the fiscal rules in the Budget System Law, certain adjustment of the deficit is permissible depending on the growth of GDP. According to that formula, with the low GDP growth of 1.5% in 2012, it is possible that the deficit of general government is up to 4.5% of GDP. However, the impact of the low growth of GDP will in 2012 reflect in violation of the fiscal rule which sets forth the upper limit of the public debt at 45% of GDP. This was the reason why the Fiscal Council proposed and the Government adopted (in agreement with the IMF) the limitation of the fiscal deficit in 2012 to a somewhat lower value than the one that would be allowed by the rule relating to deficit, or at 4.25% of GDP instead of 4.5% of GDP.

Indicators of the economic activity trends in Serbia point to deceleration of the economic activity since the first quarter of 2011. The trend of economic activities in 2011 is best illustrated by seasonally adjusted GDP indexes presented in Graph 1. After the high growth of GDP in the first quarter (Q1), economic activity started slowing down moderately as early as in the second quarter. Intensity of the last deceleration of the economy is not as strong as in the first wave of the crisis (Graph 1); however, the latest signals coming from the Euro zone, with which the domestic economy is closely linked, warn of caution.

Graph 1

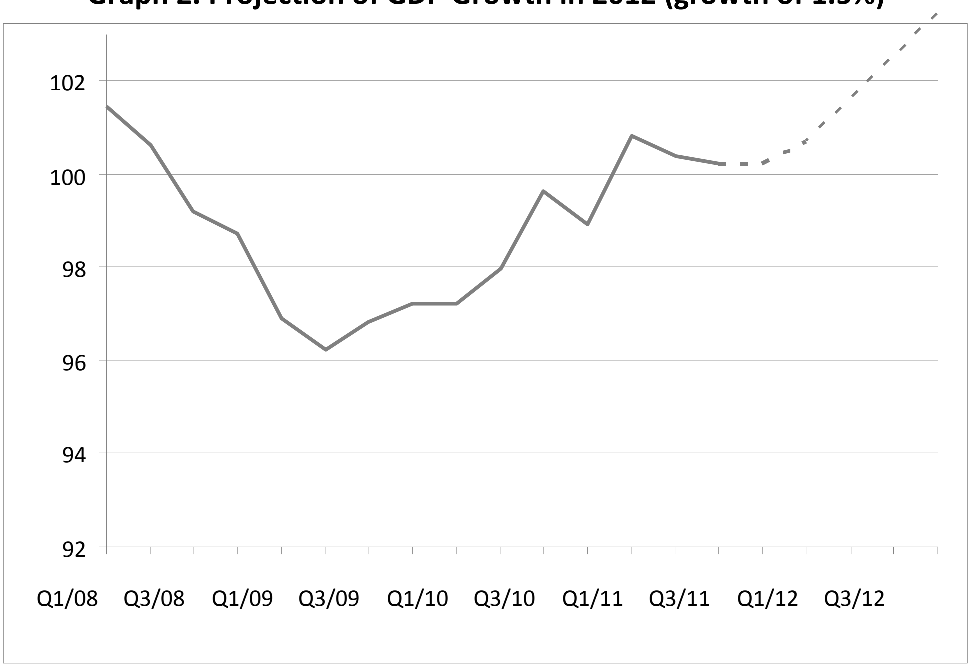


Seasonally Adjusted GDP (2008=100)

Because of the drop carried over from 2011, an exceptionally rapid recovery of economic activity is required in the next year so as to be achieved the growth rate of 1.5% of GDP. The GDP path in 2011 (Graph 1) has another unfavorable effect: because of the gradual reduction of production, the recovery in 2012 will start from the negative zone against the average of 2011. Overall economic growth in 2012 will remain low because of the drop carried over from 2011, even in the case of a solid recovery of the economy. Estimated GDP growth rate of 1.5%, although appears modest, actually involves a much stronger recovery of the economy in the next year than it would be intuitively expected.

Economic growth of 1.5% in 2012 actually means that the pace of economic recovery would accelerate from the current 0% to 4% by end of 2012. To illustrate the speed of the economic recovery that would lead to GDP growth of 1.5% in 2012, and the potential risk of non-materialization of that growth, Graph 2 presents the projection of the corresponding seasonally adjusted GDP movements in 2012. The graph shows that in spite of the initiated recovery, the year-over-year GDP growth in Q1 of 2012 will be approximately zero precisely due to the drop carried over from the end of 2011. The year-over-year growth will then pass to the positive zone and will be rising to approximately 3.7% in Q4. Total GDP growth in 2012 will be approximately equal to the average of the year-over-year growth of all four quarters – the low growth at the beginning of the year and the higher growth at the year end – which is on average around 1.5%. Another consequence of such a path of the recovery would be that with such acceleration of the economic growth carried to 2013, GDP growth of 4% could probably be achieved in that year. Therefore, the Fiscal Council has reservation about the achievement of the forecasted growth of 1.5% in 2012.

Graph 2. Projection of GDP Growth in 2012 (growth of 1.5%)



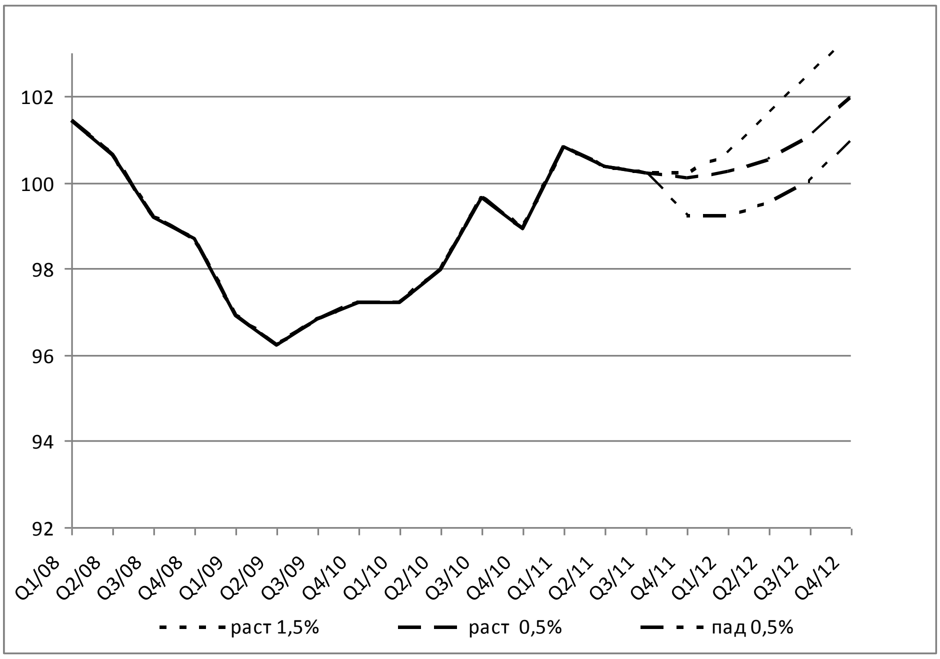
Real GDP growth of 1.5% in 2012 can be achieved only on the basis of several optimistic assumptions. Graph 2 presents the conditions necessary for GDP growth of 1.5% in the next year. They are: (1) no drop in the production in the last quarter of 2011 for which official data are still not available, or that GDP in the seasonally adjusted Q4 remains on the same level as in Q3; (2) commencement of the production recovery in Q1 of 2012, and (3) achievement of natural GDP growth rate[2] of 4% per annum as early as in the second quarter of 2012 (0.9% quarterly growth) and holds on in Q3 and in Q4. The analysis indicates that all of the three assumptions are optimistic, but also feasible, and that there are risks that the growth of economy in 2012 may be lower than planned. The

[2] Natural (potential) growth rate represents an economically possible long-term growth of the economy in Serbia, which is 4%. It is also legally defined in the fiscal rules (in the Budget System Law).

same analysis indicates that GDP growth higher than 1.5% in 2012 can be excluded with a high degree of probability since even the real growth of 1.5% will be hardly achievable.

If the recovery path similar to that in the post-2008 crisis period repeats, there are prospects for the GDP growth in 2012 to be lower than 1.5% and be at the level between -0.5% and 0.5%. Taking into consideration that estimated GDP growth of 1.5% in 2012 will depend on more optimistic assumptions, the Fiscal Council also analyzed some more conservative scenarios. In Graph 3, the Council varied different assumptions of economic activity developments in the forthcoming period. The first assumption was that the potential GDP growth rate will be achieved at a slower pace. The underlying element of such assumption was the recovery path of the economy in the first quarters after the 2009 crisis which was approximately copied to 2012. The consequence of this scenario will be the GDP growth of about 0.5% in 2012 (Graph 3). The next scenario assumes in the last quarter of 2011 a drop in production of the intensity similar to that in the 2008 economic crisis, rather than the expected stagnation. The Fiscal Council assumed this scenario based on the most recent indicators from the Euro zone (purchase orders of industrial products which precede the industrial production development registered a sharper fall in September than in the preceding wave of the crisis). In this scenario, the recovery would also start in the first quarter of 2012, although from a lower level of economic activity, or the drop carried over from 2011 would be steeper (Graph 3). The mentioned scenario would result in a total GDP fall of 0.5% in 2012, and because of the drop in Q4 of 2011 GDP growth rate would drop to 1.7% in 2011. For the time being, the Fiscal Council has not considered the possibility of commencement of a deep recession in 2012 or a W-shaped double bottom crisis believing that it is still little probable – although such a scenario cannot be excluded with certainty.

Graph 3. Projection of GDP Growth in 2012 (different scenarios)



The analysis of GDP utilization rate confirms the results that it will be difficult to achieve the GDP growth of 1.5% in 2012. Additional insight into the economic activity trends in 2012 is provided by the analysis of GDP utilization rate. Since the Republic Statistics Office (RSO) does not, unfortunately, follow up GDP utilization rate at quarterly level, the Fiscal Council's analysis is based on indirect indicators (trends of the wage bill, pensions, building activity, importation of capital goods, etc.) which describe the movements of GDP components. The analysis of these indicators in 2011 shows that the economic growth was achieved thanks to the rise of investments. Private and public consumption registered real drop, while the contribution of net exports to GDP growth was modest.[3]

Investments in 2012 will probably remain at the level from the preceding year, and will not be a locomotive of growth in 2012. The high real growth of investments, about 10% in 2011, will most probably not continue in 2012. The reason is that large investments from 2011 are in their final stage (FIAT, NIS), while borrowing for new investments was at the close of 2011 more difficult due to the significant rise of the risk premium and consequent rise of interest rate on investment credits. The Government announced by the framework budget for next year a relatively high real growth of public investments of over 15%; however, because of the small share of public investments in overall investments the announced growth will not have a crucial impact on total trends. It needs to be taken into account that temporary halt in implementation of the government's capital projects is also possible because of the elections in 2012.

The starting assumptions in this analysis indicate that private consumption will have a real growth of about 1% in 2012. Private consumption is mostly financed from wages and pensions. Real increase of the wage bill will be about 3% in 2012. Real increase of the pension bill in 2012 is the result of the pension adjustment by inflation and one-half of the 2011 GDP growth. The expected rise of pensioners also contributes to the projected real growth of the pension bill. According to the first projections, the wage bill in the public sector will have the real growth similar to that of the pension bill, and will be somewhat higher than 2.5%. In Serbia, however, the larger portion of the wage bill relates to the private sector where, in optimistic case, is expected unchanged wage bill in real terms relative to 2011 due to the decrease in the number of employees. This is the reason why the Fiscal Council holds that total real growth of the wage bill in 2012, including both the public and private sectors, will be slightly over 0.5%. As regards other major sources of private consumption (according to the experience gained in the preceding crisis), remittances will probably not change significantly, while a growth somewhat slower than in 2011 of consumer and cash credits 2011 is possible, when their real growth was around 5%. On the grounds of all of the above facts, the Fiscal Council expects a real growth of private consumption to be about 1% in 2011.

[3] Such a structure of the economic activity growth has significant implications on the fiscal policy because the tax generous consumption is decreasing while GDP components with significant tax exemptions (exports, investments) are rising. This was the reason for the real fall in public revenues in spite of the GDP growth in 2011. The share of public revenues in GDP dropped in 2011 by as much as two percentage points against 2010 – from 41% of GDP to 39.1% of GDP.

Public consumption will in 2012 have a real growth of about 1%, or similar to the growth of private consumption. Although the public consumption is a GDP component that can be most reliably assessed for the coming year, it is still not possible to do it right now. The reason is, *inter alia*, the fact that the plan of public allocations for goods and services in the next year is highly restrictive and is thus likely that some savings will not materialize and that the growth of public consumption will nevertheless be higher than planned. On the other hand, if the economic growth turns out to be less than expected and planned tax revenues do not materialize (as also indicated by the analysis of the seasonally adjusted GDP), adjustment of public expenditures will take place and, consequently, public consumption will be smaller than planned. Taking both of the mentioned possibilities into account: (1) the real growth of public consumption larger than planned, and (2) the public consumption smaller than planned − the Fiscal Council's conclusion is that a much greater probability is that the real growth of public consumption will be smaller than 1% in 2012. Because, it will be difficult to finance larger than planned public expenditures on the financial markets since the public debt in 2012 will exceed the legal limit of 45% of GDP. Possible growth of expenditures for goods and services above the plan may be achieved only in the frameworks of the envisaged budget – possibly by reduction of public investments. Such redistribution would have a neutral impact on GDP in the short run; in the long run, however, due to the larger multiplicative effect of public investments, redistribution of public expenditures from investments to consumption would have a negative impact on the economic growth.

Achievement of 1.5% GDP growth in 2012 requires a significant positive contribution of net exports to the growth of economic activity. Such a conclusion is based on the prior analysis of all GDP components in 2012 which indicates that they will have a real growth smaller than the estimated GDP growth (1.5%). A question which cannot be reliably answered to at this moment is: will net exports in the next year be able to provide sufficient contribution thanks to which the growth of economic activity would reach 1.5%? For net exports to achieve the necessary real growth in the next years, two preconditions have to be satisfied because of the small share of exports in GDP: (1) growth of exports twice as fast as that of imports, and (2) a high exports growth rate (minimum 10%) in order to sufficiently contribute to the overall growth of the economy.

The Fiscal Council deems it possible for net exports in the next year to have the growth similar or lower than that in 2011 for which reason the GDP growth rate of 1.5% would not be achieved. According to the data from previous years, after the first wave of the crisis it was precisely the growth of exports that led to the recovery of the production in Serbia in 2010. In 2012, however, the Fiscal Council is not convinced that a similar scenario could repeat. Firstly, with the recovery of the world economy in 2010 the demand was rising on the most important export markets. Currently, the deepening of the crisis in the Euro will have a negative impact on the growth of exports − particularly because the crisis has been affecting the countries such as Italy which are the most significant trade partners of Serbia. Secondly, domestic economy entered the year 2010 with a significant increase of its price competitiveness due to the real depreciation of the dinar. Currently, the strong real appreciation of the dinar in 2011 which has significantly lowered the price competitiveness of domestic products has an adverse impact on the fast growth of exports.

The Fiscal Council's assessment is that the economic activity trends roughly indicate based on currently available data that the GDP growth of 1.5% in 2012 will be difficult to achieve even in the absence of a significant deterioration of the economic situation. In the circumstances of a possible escalation of the crisis in the Euro zone, it is difficult to reliably assess the economic activity trends in 2012. The practice of the Republic Statistics Office of making retroactively frequent revisions of GDP estimates in several quarters, and years including, additionally contributes to non-reliability of the estimates. The Fiscal Council also expects at the close of March of 2012 the official data about the nominal value of GDP in 2010, noting that the revisions of these data in the earlier period used to significantly change the picture of the economy in Serbia. In spite of all non-reliabilities that are characteristic for forecasting the GDP growth, the Fiscal Council believes that there are sufficient motivations for immediate start of the planning of an adequate fiscal policy to be in place if the economic growth will be lower than planned.

3. PROJECTION OF PUBLIC REVENUES IN 2012

Total public revenues crucially depend on the trends of pubic revenues which account for 85% in the consolidated government revenues. The remaining government revenues comprise different forms of non-tax earnings. The amount of tax revenues in the next year is determined by the tax system, macroeconomic aggregates and the degree of tax revenues collection. In this analysis will be thoroughly analyzed the official planned government revenues in 2012, and will also be presented the Fiscal Council's own projection of public revenues trends in that year.

3.1. Impact of Tax System Changes on Revenues in 2012

In the Report on Fiscal Strategy and Draft Republic Budget are not envisaged the changes in the level of tax rates, width of tax rates or changes in tax expenditures (exemptions and reliefs). The exception is the customs tariffs where, in accordance with the Agreement on Stabilization and Accession, the lowering of tariff rates continues.

In 2012, pronounced redistributions of tax revenues between individual government levels are planned. The most important change which came into force in the last quarter of 2011 and whose full effects will be felt only in 2012 is the increased share of local governments in the personal income tax from 40% to 80%.[4] This change reduced the share of the Republic Budget in the personal income tax in Central Serbia from 60% to 20%, and in the territory of AP Vojvodina from 42% to 2%. The second redistribution of tax revenues relates to excise duties on oil derivatives where has been envisaged the increase of the Republic budget from 80% to 90%, and the decrease of the share of JP „Putevi Srbije“ from 20% to 10%. It has been planned that the decrease of JP „Putevi Srbije“ revenues in the amount of about 10 billion dinars from excise duties be compensated by increase of revenues based on the collection of road maintenance service charges from local communities. If local communities do not increase payments to

[4] The exception is the City of Belgrade where 70% of collected personal income tax will remain in the city budget.

JP „Putevi Srbije“ the consequence could either be the increase of losses of JP „Putevi Srbije“ and, accordingly, increase of the government consolidated deficit or a fall in the maintenance quality of local roads.

The Fiscal Council holds that significant changes in the tax system are not excluded after the elections, although such changes are not planned in the Report on Fiscal Strategy. Turbulent and often also dramatic fiscal position of numerous countries during this and a number of previous years resulted in the changes of the tax system, the purpose of which has been to reduce the fiscal deficit but also to improve the economic ambiance with such changed tax system structure.

3.2. Impact of GDP Growth Rate on Revenues in 2012

The trend of GDP volume and structure will have a dominant impact on the level of tax revenues in the next year. In the Report on Fiscal Strategy and Draft Republic Budget, tax revenues were planned based on the projected 1.5% GDP growth rate in 2012. Based on the trends recorded in the second half of 2011, the Fiscal Council's assessment is that the said GDP growth is feasible but that there are also significant risks that the growth could be smaller (see Section 2). If GDP growth is smaller than planned, with other conditions unchanged, the revenues would be smaller. On assumption that aggregate demand is rising like GDP and that there are no major changes in its structure, the reduction of GDP growth rate by one percentage point (p.p.) influences on the reduction of tax revenues by about 0.4 p.p. of GDP. Potential slower growth of GDP, caused by the stagnation of European economies or even by occurrence of a new recession, would have as a consequence smaller tax revenues in Serbia against those planned. If GDP growth rate were 0.5% in the next year instead of the currently planned 1.5%, tax revenues would fall by additional 0.4% of GDP, or by about 14 billion dinars, whereas in the case of a zero growth of GDP the revenues would be smaller by around 20 billion dinars against the plan.

3.3. Impact of the Most Relevant Tax Bases on Revenues in 2012

The trend of principal tax revenues in Serbia crucially depends on the movements in the tax bases – of personal consumption and wage bill. Tax revenues do not only depend on the GDP growth rate, but also on the changes in its structure, which occur due to different speed of growth of individual GDP components. From the point of view of tax revenues, relevant is the growth of those GDP components which represent the most important tax bases, and they are personal consumption and wage bill. Taxation of personal consumption by VAT and excise duty generates revenues of about 15.5% of GDP, which accounts for around 45% of tax revenues or 40% of total consolidated public revenues. Taxation of wages by personal income tax and contributions for social insurance generates revenues of about 14.3% of GDP, which represents about 42% of tax revenues or 37% of consolidated public revenues. In aggregate, taxation of personal consumption and wages generates almost 30% of GDP, which is about 88% of tax revenues or about 77% of total consolidated public revenues.

According to the projection of the Ministry of Finance contained in the Report on Fiscal Strategy, a drop of 0.2% is expected in personal consumption relative to 2011. The drop of personal consumption of 0.2% with the GDP growth of 1.5% implies reduced share of personal consumption in GDP by almost 2 percentage points. Slower growth of personal consumption relative to investments, and faster growth of exports relative to imports are the key components of a sustainable growth of the economy of Serbia. Faster growth of investments against other GDP components in several years to come is crucial for the economy of Serbia to accomplish a long-term (trend) growth rate of about 5% per annum. Also, a considerably faster growth of exports than that of imports is a condition necessary to reduce the foreign trade deficit and prevent the external debt crisis. From the point of view of tax revenues, however, a slower growth of personal consumption leads to slower growth of tax revenues because in the structure of GDP increases the share of the components that are not taxed by consumption taxes (investments and exports).

Projection of VAT based revenues as presented in the Report on Fiscal Strategy is to a certain extent inconsistent with the projection of personal consumption. If personal consumption would register a real drop of 0.2% in 2012 as expected in the Report on Fiscal Strategy, the consequence thereof would under other unchanged conditions be a smaller share of revenues from consumption tax in GDP. Instead of that, in the Report is expected a growth of the share of VAT and excise duties based revenues in the circumstance of a drop of personal consumption and reduction of its share in GDP. The significantly faster growth of exports than that of imports, projected in the Report, implies that the reduction in collection of domestic VAT (due to the growth of VAT refund at exports) will be larger than the growth of collection of VAT on imports. According to the Fiscal Council, if the official projections about the real drop of personal consumption by 0.2% in the next year materialize, instead of the expected growth of 0.1 p.p. of GDP in the share of revenues from VAT would be recorded a real drop by about 0.2 p.p. of GDP. Apart from the lowering of the real level of personal consumption, the change in its structure will also have a negative impact on VAT based revenues. Because of the expected worsening of the economic situation, in the next year is in the case of personal consumption expected an increased share of products that are taxed at the rate of 8%, as well as an increase in natural consumption which is not subject to VAT taxation. Due to increased share of natural consumption and products taxed at the rate of 8%, the drop in the share of VAT generated revenues in GDP could be around 0.3 percentage points.

The Fiscal Council's analyses lead to a conclusion that the projected drop in real consumption is little probable in the next year under the assumption that GDP growth of 1.5% materializes. Detailed analysis made by the Fiscal Council shows that personal consumption in 2012 will register a real growth of around 1% instead of a fall, and that real growth of investments and net exports will be smaller than projected in the Report (see Section 2). It arises that VAT based revenues will be rising at a pace slower than that of GDP and thus lead to reduction of their share in GDP; however, it will be smaller than the one envisaged in official projections. If GDP will be growing in the next year at the rate of 1.5%, and personal consumption at the rate of 1%, the drop in the share of VAT based revenues in GDP would be about 0.05 p.p. However, VAT based revenues would in this case also fall because of the changed structure of personal consumption in the direction of increased share of products taxed at the rate of 8% and non-taxable natural consumption. Additional decrease of VAT based revenues due to the changed personal consumption structure would be somewhat smaller (because overall personal consumption would be increasing in real terms rather than decreasing), and would be about 0.05 p.p of GDP. Total reduction of the share of VAT based revenues would in 2012 be smaller than in 2011, slightly over 0.1 p.p., due to the slower growth of personal consumption and its changed structure.

The Fiscal Council estimates that VAT based revenues will in the next year be smaller by around 0.2 percentage points of GDP than projected in the Report on Fiscal Strategy. However, the drop in revenues will nevertheless be smaller than it follows from the personal consumption fall projected in the Report on Fiscal Strategy. The assessment of the Fiscal Council is that the projections of revenues from excise duty according to which the growth of their share by 0.1 p.p. in GDP is realistic, taking into account that excise duties were raised in the course of 2011 and that the higher level has already been carried over to next year. In aggregate, the Fiscal Council's assessment is that VAT and excise based revenues will be smaller than planned by about 0.1% of GDP.

The second key determinant of tax revenues is the trend in the wage bill. The wage bill schedule represents the result of the change in average wages and the change in the number of registered employees, i.e. those employees who have employment records and pay taxes and contributions. The Report on Fiscal Strategy assesses that the number of registered employees will rise moderately, while average real wage will be rising approximately as the real GDP. From these assessments was obtained a consistent result according to which the wage bill, as well as the revenues from personal income tax and contributions will be rising at approximately the same speed as GDP, i.e. that their share in GDP will remain unchanged. However, the Report on Fiscal Strategy projects that the share of revenues from the contributions for social insurance will in the next year increase by 0.2 p.p. of GDP, probably based on the expected improvement in the collection rate.

The trends in the labor market during 2011 lead to a conclusion that the number of employees will also go down in the next year. The Fiscal Council estimates that with the materialization of the planned GDP growth rate of 1.5% the number of registered employees could fall by about 1% (i.e. by about 20 thousand workers). In view of the situation prevailing in the economy and the risks existing in the EU, this estimate may be considered conservative. In other words, the reduction of employment could even mean a larger figure. The Fiscal Council's estimates that real wages in public sector will rise and stagnate in the private sector and that as a result of that real growth of average wage will be about 1% (see Section 2). It follows from the above that the wage bill will in real terms remain unchanged (growth of real wages and reduction in the number of employees cancel out each other), which means that revenues from personal income tax and contributions will remain unchanged in real terms. Real unchanged revenues from personal income tax and contributions with real GDP growth of 1.5% and unchanged degree of collection imply reduction of their share in GDP by about 0.2 p.p. If the degree of collection would nevertheless rise by 0.2 p.p. of GDP, then the share of revenues based on personal income tax and contributions for social insurance in GDP would remain unchanged in real terms – better collection would be neutralized by the decrease in the number of employees and the growth of real wages slower than the growth of GDP. The Fiscal Council estimates that the improvement of the rate of collection of contributions by 0.2 p.p. of GDP is the maximum that can be achieved in the next year (for details see point 5 of this Section). Accordingly, the Fiscal Council estimates that revenues from personal income tax and contributions for social insurance are overestimated by about 0.2 p.p. of GDP, even if the rate of collection of contributions improves.

The Fiscal Council believes that due to the deterioration of the situation in economy in the last three quarters of 2011 the revenues from the profit tax could also be smaller than planned. The share of profit tax in GDP could be below the planned figure by about 0.1 p.p. of GDP, i.e. could be at the level of 2009 and 2010. The Fiscal Council estimates that other tax revenues, such as those from customs tariffs and others are realistically projected in the Report, on the basis of the data available at the time of their preparation.

Summing up the above, the Fiscal Council's estimate is that the share of tax revenues in GDP will in 2012 be probably smaller by about 0.4% (around 14 billion dinars) than planned in the Report on Fiscal Strategy.

3.4. Evaluation of Projected Non-Tax Revenues

Non-tax revenues include a heterogeneous group of government revenues such as fees, stamp duties, fines, etc. The Report on Fiscal Strategy estimates that non-tax revenues will increase on one-off basis by 0.4 p.p. of GDP. The planned one-off increase in the share of non-tax revenues in GDP would be achieved by the government's collection from bankruptcy estate as well as by the collection of dividends from Telekom Serbia and EPS. Thanks to one-time jump of non-tax revenues, the government's fiscal deficit in 2012 was reduced by 0.5 p.p. of GDP. Based on the talks with the Government representatives, the Fiscal Council holds that reduction of the fiscal deficit based on one-off increase of non-tax revenues is feasible. However, in question is the one-time revenue that cannot be counted with in the years beyond 2012. Moreover, the taking of public companies' dividends for reducing the fiscal deficit has negative consequences for their operation.

3.5. Impact of Changed Tax Collection Rates on Tax Revenues

In Serbia, a thorough research of the gray economy has not been conducted for quite a long time. Therefore, arbitrary estimates not corroborated by strong arguments appear in the public. On the basis of some partial researches carried out in Serbia, comparisons with the researches in similar countries, comparison of the tax rates, and the like, it is estimated that the volume of gray economy in Serbia could amount between 20% and 30% of GDP. It may be concluded at the first glance that there is an enormous room for improvement of the tax collection which could provide for the growth of public revenues that would eliminate the fiscal deficit or which could allow a significant decrease of the tax rates.[5]

[5] Another way by which is overestimated the possibility of achieving additional tax revenues through taxation of the gray economy is the assertion that it amounts to 40% or 50% of GDP – without any evidence to corroborate such estimates. The large share of the government sector in the economy of Serbia (which is bad from the point of view of

Excessive expectations of additional public revenues from the gray economy are unrealistic for two basic reasons. First, in broader public a distinction is most often not made between the estimate of the volume of turnover in the gray economy and the added value in the gray economy. Estimates saying that the gray economy is around 30% of GDP in Serbia relate to the total turnover in the gray economy. On the other hand, the key parameter for achieving additional revenues through taxation of the gray economy is the added value, not the turnover. Empirical researches show that, depending on the structure of economy, the added value in the gray economy is two to four times smaller than estimated turnover in the gray economy.[6] Second, it is worth noting that gray economy is present in all countries of the world, including those most developed. Some estimates of potential additional revenues from the gray economy taxation, which can be found in broader public, imply reducing the gray economy in Serbia to a considerably lower level relative to comparable countries in the region - and bring it down to the level existing in the Scandinavian countries or even below it. The Fiscal Council is of the view that such estimates are not realistic but that, no doubt, there is a possibility for improvement of the tax collection. However, improvement of the tax collection requires a thorough reform of the tax administration, increase of their independence, increase of the number of tax administration staff, unburdening of the tax administration of various obligations not pertaining to its scope of operation, non-selective application of forced collection, etc. All these measures require a certain time period so that results cannot be expected in the short run.

An additional aggravating circumstance for a substantial improvement of tax collection in the next year is the economic crisis during which the tax collection falls in all countries. A part of companies, particularly the big ones, regularly present their tax returns but at the same time submit the proofs of their inability to pay the tax liabilities and seek deference of their payment. Moreover, on the basis of some empirical researches the largest portion of Serbia's gray economy is concentrated in the area of black labor, namely, in the sector of entrepreneurs, small and micro enterprises, as well as in some activities where detection of gray economy is by nature of the works rather difficult (building industry, catering, etc.). Curbing of gray economy in these activities is possible only if the aforementioned reforms of the tax administration are implemented.

Summing up the above arguments, the Fiscal Council holds that there is a certain room for reduction of the gray economy, but that only after the economy's exit from the crisis it will be possible to apply a general unselective campaign for the reduction of gray economy, which would render significant results.

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economic efficiency) reduces the room for the gray economy. Overestimation of the gray economy is frequently used for the purpose of demanding lower tax rates.

[6] The difference between the turnover and added value in the gray economy can be best explained by a simple example. If a citizen pays to a plumber EUR 100 to fix a plumbing problem at his place, and the plumber does not report this income – the turnover in the gray zone increases by EUR 100. However, this amount also includes the value of the production material on which (probably) VAT has been calculated and paid. Therefore, the added value of this transaction in the gray zone can be 25, 50 or 75 Euros – depending on the relative production material/invested work ratio.

3.6. Summary and Recommendations

The Fiscal Council expects that total pubic revenues in 2012 will be smaller than the plan by about 0.4% of GDP, or by about 14 billion dinars. Even if the planned GDP growth rate of 1.5% materializes in 2012, tax revenues will be smaller by about 0.4% of GDP (around 14 billion dinars). Non-tax revenues will probably be at the level of the plan, on condition that planned non-tax revenues materialize, such as planned collection of assets from bankruptcy estates. If GDP will be growing slower relative to the plan, the revenues will be smaller – decrease of GDP growth rate by 1 p.p. implies reduction of tax revenues and increase of fiscal deficit, under other unchanged conditions, by 0.4 p.p. of GDP. Thus, for example, if GDP would be rising in next year at the rate of 0.5%, total revenues would be smaller by 1 p.p of GDP, i.e. by about 35 billion dinars. If expenditures were not decreased by the same amount, the decrease of revenues would directly shift to the growth of fiscal deficit and public debt. Improvement of debt collection creates a certain (modest) room for the growth of revenues, but its amount is difficult to estimate. The Fiscal Council estimates that fiscal revenues for the years 2013-2014 are overestimated by 0.6 to 0.7 p.p of GDP, which means that the fiscal deficit and public debt, with the given public expenditures, are underestimated by the same amount. The overestimation of revenues in the mentioned years is additionally increased because of the expected growth of the share of VAT based revenues in GDP, without any measures being planned at the same time for achieving this growth. The Fiscal Council is recommending to the Government to prepare additional measures for decreasing the expenditures and/or increasing the revenues by 0.4% of GDP in 2012, or by 0.6 to 0.7 p.p. of GDP in 2013 and 2014. Implementation of the above measure is a condition indispensable for reduction of the fiscal deficit and for bringing back the public debt/GDP ratio below the limit set forth by law.

The Fiscal Council is recommending to the Government to prepare alternative fiscal policy plans because of the high uncertainty of the economic situation in EU. Such plans would prevent additional increase of the fiscal deficit and public debt, even if the growth of GDP would in next years be slower than foreseen in the Report on Fiscal Strategy. Such plans could also include more radical measures that would ensure the planned reduction of fiscal deficit and return of the public debt into the frameworks set forth by law.

4. EVALUATION OF PLANNED PUBLIC EXPENDITURES IN 2012

By the fiscal framework for 2012 and the Report on Fiscal Strategy and Draft Republic 2012 Budget public consumption has been planned to have a growth of 2.7% in real terms. As GDP growth estimated for next year is lower than the growth of expenditures and is only 1.5%, the share of public expenditures in GDP will rise from 43.7% in 2011 to 44.2% in 2012. Changes have occurred in the structure of public expenditures – expenditures for some budget items are registering above-average growth, which is then compensated by sharp cuts in allocation for net budgetary lending, subsidies (only at the Republic level), and purchase of goods and services. Even more significant is the change of the public consumption structure when viewed through expenditures of different government levels – expenditures of local governments have a high growth while expenditures at the republic level are decreasing in real terms. The Fiscal Council holds that it will be difficult to achieve the planned framework of public expenditures in 2012 from the Report on Fiscal Strategy and Draft Republic 2012 Budget.

Table 4.1. Consolidated Government Expenditures in 2011 and 2012

	billion dinars		(% GDP)	
	2011	2012	2011	2012
PUBLIC EXPENDITURES	**1466.6**	**1568.3**	**43.7**	**44.2**
Current expenditures	1323.8	1419.1	39.4	40.0
Expenditures for employees	337.3	361.4	10.0	10.2
Purchase of goods and services[1)]	245.3	257.3	7.3	7.2
Interest repayment	46.0	63.5	1.4	1.8
Subsidies	85.4	97.2	2.6	2.7
Social welfare and transfers	609.8	639.7	18.2	18.0
of which: Pensions[2)]	*446.2*	*477.1*	*13.3*	*13.4*
Capital expenditures	116.1	141.7	3.5	4.0
Net budgetary lending	26.7	7.4	0.8	0.2

[1)] Including other current expenditures
[2)] including pensions of military insured persons

Real growth of current and capital expenditures and a steep fall of net budgetary lending have been planed. A detailed analysis of the structure of public expenditures in 2011 and 2012 is presented in Table 4.1. The Report on Fiscal Strategy envisages that in 2012 current public expenditures will have a real growth of about 3%, capital investments of about 17%, while allocations for net budgetary lending will be reduced to one-fourth against 2011.[7] Economically rather favorable fact has caught the attention of the Fiscal Council, namely, it has been planned that allocations for capital investments in 2012 be almost equal to the government consolidated deficit (4% against 4.25%), which means that current revenues and current expenditures are almost balanced.

Current public expenditures are rising in 2012 because of the legally defined pension and wage indexation and the large growth of allocations for interest. Due to the growth of current expenditures faster than that of GDP (insignificantly also due to methodological changes), their share in GDP will go up from 39.4% in 2011 to 40% of GDP

[7] Such a steep reduction of net budgetary lending is a consequence both of actual trends and the changed classification of public expenditures. Some items maintained earlier as net budgetary spending (subsidized credit for liquidity purposes) are now classified in current expenditures. If the effect of changed methodology were excluded, current public expenditures would grow in 2012 by 2.5% in real terms, and net budgetary lending would be halved against 2011.

in 2012. Increase in current expenditures share in GDP is undesirable in economic sense, but is unavoidable in 2012 because of the government's obligations defined by law, and also the obligation of paying interest on the public debt in the circumstances of the low GDP real growth of only 1.5%. If viewed in nominal values, current public expenditures next year will be nominally larger by about 95 billion dinars against 2011 (Table 4.1). The largest portion of this increase relates to the legally defined allocations for pensions and wages in the public sector. Allocations for pension in 2012 will be by about 30 billion dinars larger than in 2011, while allocations for wages will be larger by about 25 billion dinars. When to this amount is added the growth in allocations for interest payment of around 20 billion dinars and when the values are adjusted by the changes in the classification, one comes to a conclusion that the remaining (mainly discretionally) government current expenditures remain, in real terms, at unchanged level as in 2011.

The Fiscal Council's assessment is that projected allocations for pensions and wages in the public sector are objective. Pensions and wages in the public sector will be adjusted by inflation (and one-half of GDP growth) on two occasions in 2012 according to the Budget System Law – in April and October. In April, pension and wage indexation will relate to the inflation from the period October 2011 – March 2012 and one-half of the realized GDP growth in 2011, and in October by the inflation in the period April–September 2012. The growth of allocations for pensions will also be impacted by the growth in the number of pensioners in the next year. The Fiscal Council's estimate, in conformance with the projections of the National Bank of Serbia (NBS), is that in the period October 2011 – March 2012 it will be around 3%, and in the period April – September 2012 slightly below 1%. One half of GDP growth in 2011 is estimated to be around 1%, and increase in the number of pensioners in 2012 about 1.5%. Under such assumptions, the Fiscal Council estimates that for pensions will in the next year be allocated 478 billion dinars, which is almost identical to the estimate from the Report on Fiscal Strategy for 2012, which is 477 billion dinars. According to the Fiscal Council's estimate, allocations for wages in the public sector will be about 356 billion dinars while according to the fiscal framework for next year these allocations are to be about 361 billion dinars. The difference most probably arises from the beginning of the application of the new Law on Police which will lead to increased expenditures for the Ministry of Interior staff by about 4 billion dinars. Taking into account this figure as well, the Fiscal Council holds that both the projected allocations for public sector employees, as well as the projected pensions are in harmony with the Fiscal Council's estimates.

The envisaged high growth of allocations for interests is well assessed and is in conformance with the correct, conservative approach to budget expenditures planning. The envisaged real growth of interest based expenditures in next year is about 30%, from 46 billion dinars in 2011 to 63 billion dinars in 2012. The high growth in interest repayment results from the public debt growth over the period of several previous years, but also from the increase of average borrowing interest rate as major part of the new borrowing (treasury bills, commercial banks, Euro bonds) bears a considerably higher interest rate than earlier contracted credits with international financial institutions. At this point in time, projection of a fully reliable estimate of allocations for interest in the next year is difficult. The first difficulty in estimating these expenditures is the fact that a larger portion of the public debt is denominated in foreign currency. Thus, the exchange rate of the dinar will have a significant impact on interest payments. Another unknown is the interest rate movement on short-term treasury bills that are revolved during the year. Interest rate on issued treasury bills depends on the inflation movement, country risk and the like, so that it is always difficult to be predicted. The Fiscal Council is of the opinion, therefore, that conservative approach is adequate in planning the allocations for this purpose (provision of somewhat larger amounts of assets for this purpose), which was applied in defining the fiscal framework for 2012.

Expenditures for goods and services and subsidies have been planned more conservatively. In 2012 has been planned a smaller relative drop of these allocations against GDP: for goods and services – reduction of the share in GDP from 7.3% to 7.2%, while allocations for subsidies fictitiously increase the share in GDP from 2.6% to 2.7%, but it is the consequence of the attaching to the subsidies of a part of public expenditures which were earlier maintained in net budgetary lending. There was no room in the budget for larger allocations for the purchase of goods and services and subsidies because they had been previously defined: the fiscal deficit level, legal government obligations (wages, pensions, social allowances, etc.), and the obligations of public debt servicing. As in question is the forcible conservative planning of goods and services and subsidies the Fiscal Council has reservations with regard to credibility of these reductions. A more detailed analysis of these expenditures is presented per individual government levels where the risks of non-materialization of the planned savings are more clearly seen (see Section 5).

High and desirable real growth of capital expenditures has been planned in 2012. According to the Report on Fiscal Strategy, expenditures for capital investments in 2012 will grow by about 17% in real terms. Due to this growth, allocations for investments in consolidated 2012 budget will reach the level of 4% of GDP. The view of the Fiscal Council is that establishment of a rising trend of public investments is economically desirable. Its view is also that this is just the first step in a good direction and that increase in the share of investments needs to be over 4% of GDP on a lasting basis.

Significant decrease of net budgetary lending has been envisaged in 2012. The reason for the sharp decrease is the finalization of joint investment of the Government and the Italian FIAT in Kragujevac, which was mostly financed from this budget item, but also the shift of a part of expenditures that were earlier classified as net budgetary lending to the chapter of subsidies. However, it needs to be taken into account that the decrease of net budgetary lending in the next year is significantly larger than it could be explained only by these factors. From the chapter of net budgetary lending were in 2011 funded specific-purpose credits for spurring production and exports, various subsidized credits through the Development Fund – for uniform regional development, for investments and consumer credits for the purchase of domestically manufactured products, for stimulating the quality of catering supply of natural persons, small and medium-sized enterprises in the area of tourism, etc. The Report on Fiscal Strategy does not have as attachment any credible plan of the envisaged decreases for the mentioned purposes by which the desired objectives would be accomplished.[8]

5. FISCAL FRAMEWORK FOR INDIVIDUAL GOVERNMENT LEVELS

Due to the amended legal regulations in 2011, primarily the amended Law on Local Self-Government Financing, in 2012 emerged the pronounced imbalances in the movement of revenues and expenditures of individual general government sectors. In Tables 5.1-5.3 are presented the revenues, expenditures and deficit of individual government levels. Large differences between different government levels are evident – local self-governments are spending much more than in previous years (double-digit real increase of expenditures of the local self-governments) while almost all necessary savings are accomplished at the Republic level by austere saving measures in several budget items.

Table 5.1. Public Revenues of the Republic of Serbia per Different Government Levels, 2011-2012

	Revenues (billion dinars)		
	2011.	2012.	Real growth (2012/2011)
Republic (all funding sources)	752. 0	801. 0	2. 3
Republic by narrower definition	703. 9	750. 1	2. 4
Own revenues [1)]	48. 1	50. 9	1. 7
Local self-government and Vojvodina	238. 4	285. 7	15. 1
RHIF	193. 9	209. 1	3. 6
PIO Fund	501. 7	564. 0	8. 0
PIO Fund, without transfers	257. 7	277. 6	3. 5
NES	35. 3	34. 3	-6. 7
JP „Putevi Srbije“	36. 1	28. 7	-23. 6
General Government (consolidated)	1313. 1	1416. 1	3. 3

[1)] Own revenues by IMF definition and the Report on Fiscal Strategy. In the Law on the Republic 2012 Budget larger own revenues are presented due to broader capture. For the needs of analysis, the definition the Fiscal Council is using describes the movements more reliably.

Table 5.2. Public Expenditures of the Republic of Serbia per Different Government Levels, 2011-2012

	Expenditures (billion dinars)		
	2011	2012	Real growth (2012/2011)
Republic (all funding sources)	891. 8	941. 6	1. 4

[8] As an additional illustration of the size of the decrease in expenditures for net budgetary lending can serve the fact that these expenditures in 2007, before the crisis and before the start of the investment project with FIAT, amounted to 15 billion dinars and are currently brought down to 6 billion dinars only.

Republic by narrower definition	852. 8	890. 7	0. 3
Expenditures from own revenues[1)]	39. 0	50. 9	25. 4
Local self-government and Vojvodina	250. 4	295. 1	13. 2
RHIF	193. 9	209. 2	3. 6
PIO Fund	501. 7	564. 0	8. 0
NES	35. 3	34. 3	-6. 7
JP „Putevi Srbije“	37. 7	30. 9	-21. 3
General Government (consolidated)	1466. 6	1568. 3	2. 7

Note: expenditures of the Republic also include the project loans (according to IMF methodology and the Report on Fiscal Strategy), which are not included according to the Republic Budget Law

[1)] Expenditures from own revenues according to IMF definition and the Report on Fiscal Strategy. The Republic 2012 Budget Law presents larger expenditures from own revenues due to broader capture. For the needs of analysis, the definition the Fiscal Council is using describes the movements more reliably.

Table 5.3. Fiscal Result (deficit) Republic of Serbia per Different Government Levels, 2011-2012

	Deficit (billion dinars)		
	2011	2012	Difference (2012 -2011)
Republic (all funding sources)	-139,8	-140,6	-0,8
Republic by narrower definition	-148,9	-140,6	8,3
Own revenues[1)]	9,1	0,0	-9,1
Local self-government and Vojvodina	-12,0	-9,5	2,6
RHIF	0,0	0,0	-0,1
PIO Fund	0,0	0,0	0,0
NES	0,0	0,0	0,0
JP „Putevi Srbije“	-1,6	-2,1	-0,6
General Government (consolidated)	-153,5	-152,2	3,1

Note: Deficit of the Republic is larger than that from the Law on 2011 and 2012 Budget because Republic expenditures also include project loans (according to IMF methodology and the Report on Fiscal Strategy).

[1)] Own revenues according to IMF definition and the Report on Fiscal Strategy. The Law on Republic 2012 presents larger own revenues and expenditures due to broader capture. For the needs of analysis, the definition the Fiscal Council is using describes the movements more reliably.

5.1. Republic Budget According to Narrower Definition

In 2012, the Republic budget loses a part of revenues (net effect of about 40 billion dinars) which are redirected to the local self-government. By the amendments of the Law on Local Self-Government Financing the share of the local self-government in the revenues from personal income taxes rose from 40% to 80% against the decrease of revenues of the Republic government level.[9] The amendments of the Law did not envisage for the local level to assume simultaneously with the financial assets a part of the obligations of the Republic government level. For this reason, the republic budget is

[9] The exception is the City of Belgrade to which will pertain 70% of collected personal income tax.

in 2012 deprived of about 40 billion dinars (it would additionally have if the mentioned amendments of the Law had not been adopted),[10] which will have to be compensated by savings or additional revenues.

The Republic budget increases revenues by 10 billion dinars in 2012 as it will get a part of the excise duties that used to pertain earlier to JP „Putevi Srbije“. The Republic government level get additional revenues of 20 billion dinars from the excise duty on fuel which earlier would be earmarked for JP „Putevi Srbije“, but with the obligation that about 10 billion of such assets be transferred back to this enterprise. JP „Putevi Srbije“ discontinues to maintain in 2012 a part of the roads which are now classified as local, and the obligation for the roads maintenance passes onto the local self-government. Net effect of these changes is that the republic budget has an increase in its revenues by about 10 billion dinars, JP „Putevi Srbije“ has fewer obligations with regard to local roads' maintenance by about 10 billion dinars (and similar decrease in revenues, Table 5.1.), while the local government level gets a new obligation to maintain local roads which amounts to 10 billion dinars that is financed from own revenues.

A part of the decrease in the Republic revenues in 2012, equal to 15 billion dinars, is compensated by one-off inflow from enterprises in bankruptcy. The Republic budget will gather in 2012 additional 15 billion dinars under the non-tax revenues chapter as it has been planned to collect from bankruptcy estates the government's outstanding claims against the companies in bankruptcy and the expected collection of dividends larger relative to 2011. The Fiscal Council welcomes the need for implementing certain measures intended to make up for the drop in revenues of the general government level, but also warns that by such an approach the problem will be resolved on a temporary rather than on a lasting basis.

Obligations of the Republic are increasing vis-à-vis other budgetary beneficiaries, primarily vis-à-vis the PIO Fund. The Republic has to ensure additional 15 billion dinars for the PIO Fund in 2012 taking into account that planned increase in expenditures for pensions in the next year is around 35 billion dinars[11] and the growth of revenues from contributions for the PIO Fund is only 20 billion dinars. Accordingly, the Republic government level has to increase the transfers to the PIO Fund in 2012 by about 15 billion dinars. However, if the planned revenues from contributions were overestimated by 5 to 10 billion dinars, as the Fiscal Council expects them to have been, the republic government level will also have to compensate that difference by increased transfers.

The Report on Fiscal Strategy and Draft 2012 Budget envisage the Republic deficit (by narrower definition) to go down by about 8 billion dinars in 2012 against 2011. Although the Republic deficit by broader definition remains in 2012 almost unchanged in

[10] Amendments of the Law started to be applied in October 2011 so that the Republic government level surrendered already in 2011 about 10 billion dinars to the local self-government. For this reason, the Republic revenues dropped by 30 billion dinars due to smaller share in personal income tax in 2012 against 2011; however, the real loss of the republic government level is about 40 billion dinars in 2012.

[11] Starting from 2012, through PIO Fund are also paid out military pensions because of which the expenditures of this Fund and the Republic transfers are rising significantly; however, this effect is neutral in balance sheet terms from the angle of the Republic.

nominal terms against 2011, the republic institutions that have their own revenues[12] will no longer have a surplus in 2012 (Own Revenues - Table 5.3). For this reason, the Republic (by narrower definition) will have to realize additional savings in 2012, or to reduce its deficit in next year by about 8 billion dinars.

The Fiscal Council's analysis indicates, therefore, that assets to be disposed of by the republic government level (by narrower definition) in 2012 will be significantly smaller relative to the preceding year. Table 5.1 shows that public revenues of the Republic in 2012 have a real growth of 2.3%. However, this figure is relativized by the fact that the Republic actually does not dispose of a part of its posted revenues. Namely, some inflows which appear in the Republic budget in 2012 are immediately transferred to other budgetary beneficiaries.[13] Moreover, obligations of the Republic are increasing towards other government levels – concretely, the Republic transfers to the PIO Fund are increasing by about 10 billion dinars. When to all this is added the fact that the largest portion of the public debt is serviced from the Republic budget, and that expenditures under interest payments in 2012 will cost the republic budget about 20 billion dinars more than in 2011, it is clear that the republic government level actually disposes in 2012 of a significantly smaller amount of assets than in 2011.

The Fiscal Council assesses that the good news is that expenditures for subsidies, net budgetary lending and purchase of goods and services are decreasing, but that it will be difficult to accomplish their planned sharp cut in 2012. Because of the mentioned considerably smaller available assets of the republic budget in the next year, allocations for subsidies, net budgetary lending and purchase of goods and services in 2012 will be by about 25 billion dinars nominally smaller than in 2011. If viewed through real changes against the preceding year, allocations for the purchase of goods and services in 2012 will fall in real terms by 11% against 2011, allocations for subsidies and net budgetary lending (combined) by even 25%. Decrease of expenditures of such intensity in the important items of the budget has not been recorded in the recent practice of conduct of public finance in Serbia. The Fiscal Council particularly points to the worrying possibility of the plan's materialization with a high rise of arrears which will then fully annul the point of planned savings.

The Fiscal Council holds that a part of competences needs to be shifted to local government level. The republic 2012 budget has significantly smaller revenues and significantly larger obligations than in the preceding year. Taking into account the legal changes due to which the revenues of the local self-government markedly increased, the Fiscal Council holds that a part of the competences needs to be shifted form the republic government level to the local government level in order to be restored the lost balance in public finances.

[12] These are different Republic Funds (Environment Protection Fund, Waters Fund, Forests Fund, etc.), ministries and special directorates within ministries which collect assets based on various stamp duties, fees and fines.

[13] The City of Belgrade surrenders 10% of personal income tax to undeveloped municipalities (about 5 billion dinars), such assets appear as revenue at the Republic level but also as expenditure within the item "transfer to local governments" – which increases both the revenues and expenditures of the Republic although the Republic does not dispose of them. Similarly, the Republic gets in starting from 2012 all revenues from the excise duty on fuel, which increase its revenues by about 20 billion dinars but, on the other hand, the Republic has the obligation to transfer a part of these assets (about 10 billion dinars) back to JP „Putevi Srbije".

The Fiscal Council is of the view that savings need also to materialize in own budgetary beneficiaries' revenues. At the same time, while the republic budget is decreasing the deficit and planning sharp cuts in consumption, the use of own revenues of budgetary beneficiaries is growing in 2012 by 20%-25%[14] in real terms (Table 5.2). Although the Fiscal Council has certain reservation with respect to full materialization of the planned spending of own budgetary beneficiaries' revenues, as currently planned, there is no doubt that certain funds will significantly increase expenditures, for example, the Environment Protection Fund, the Republic Waters Fund, the Republic Forests Fund, etc. The Fiscal Council believes that the high growth of spending of own revenues in 2012 absolutely requires clear argumentation. Also, it is necessary to consider a possibility of joining certain funds with the competent ministries and thus bring their operation and revenues they generate under the strict budget control.

5.2. Local Government Level

Local self-government is strongly increasing expenditures in 2012 in line with more assets it disposes of after the start of application of the amended Law on Local Self-Government Financing. The Fiscal Council's analysis indicates that certain increase of expenditures at local level can be justified: maintenance of roads which passes to the competence of local governments, payment of accumulated outstanding debts, and increase of investments with simultaneous take-over of certain local investment projects from the Republic level (NIP). However, the Fiscal Council's assessment is that new assets that are surrendered to the local government (about 40 billion dinars) exceed by far all of the mentioned obligations, and that it is necessary to consider a possibility for the local government level to take over certain functions from the Republic level and/or to decrease the fiscal deficit.

Expenditures for the purchase of goods and services at the local level are increasing by more than 10 billion dinars against 2011. A part of this increase (slightly below 10 billion dinars) can be justified by the obligation of maintaining local roads, which passes to the local self-government starting from 2012. Accordingly, the local self-government shall have to enter into the contracts for road maintenance for which it has become competent instead of JP „Putevi Srbije“, which will be posted within the purchase of goods and services item. It is, however, questionable to what extent this change will be implemented efficiently: how qualitative has been the requalification of the roads, is the local self-government prepared and ready for this obligation, i.e. does it have the adequate administrative capacity for additional obligations, but also what is happening with the administration in JP „Putevi Srbije“ which was earlier carrying out these procurements? When we exclude the new obligations of road maintenance, the local government level is in spite of that increasing its allocations for the purchase of goods and services. It may be that a part of such assets will be used for covering the potential arrears, but as for the time being there are no reliable records of the arrears at the local level, this assumption cannot be confirmed by the Fiscal Council. It is noteworthy,

[14] If data from 2011 revised budget are compared with the Draft 2012 Budget Law, one gets the real growth of expenditures from own revenues in 2012 of around 25%. For the reason that all savings in 2011 will not materialize in these expenditures, as planned by the revised budget (see Section 1), the real growth will be smaller in 2012.

however, that the republic government level is decreasing in 2012 the allocation for the purchase of goods and services by about 4 billion dinars relative to 2011.

Subsidies at the local level are in 2012 increasing by about 10 billion dinars, from 29 billion dinars to 39 billion dinars. Although a part of this increase probably also relates to the difficulties in operation and arrears of local public companies, increased allocations for the subsidies of the local self-government in the next year by one-third against 2011 account for an additional indication that the local self-government is strongly increasing expenditures for the same purposes where the Republic is forced to accomplish significant savings. Namely, allocations for the same purposes at the Republic level will in 2012 be reduced by about 5 billion dinars.[15]

Capital investments of the local self-government are increasing by more than 15 billion dinars against 2011. A part of this increase relates to the takeover of competences for the implementation of certain local investment projects instead of the abolished Ministry for NIP. However, when these obligations are excluded, there is still the real growth of investments of the local self-government of about 15%. The Fiscal Council assesses positively the growth of capital investments, but also keeps the reservation with regard to appropriate selection of priority projects. Also, in the circumstances of a very probable overshooting of the targeted deficit in the next year, it is necessary to consider a possibility of accomplishing the savings and reducing the deficit of the local self-government, which remains in 2012 despite the significant increase of revenues, rather than of implementing certain projects.

The Fiscal Council holds that increase of revenues of the local self-government needs to be accompanied by a shift of a larger number of competences from the Republic level. The Fiscal Council's analysis indicates that a considerable portion of the increase of local self-government expenditures in 2012 is not economically justified and that it is not appropriate for the macroeconomic environment where the public debt is exceeding the legal limit of 45% of GDP, and where at the Republic level are implemented austere measures for reduction of budget expenditures. Even in the case of utilization of additional revenues of the local self government for payment of accumulated outstanding debts, one has to take into account the fact that these payments are of one-off nature and that, once repaid, larger revenues will on a lasting basis remain at the local level. This is the reason why the Fiscal Council believes necessary the urgent rethinking of a possibility to shift certain competences from the Republic to the local government level, probably from the domain of social welfare.

5.3. Obligatory Social Insurance Funds

Funds of obligatory social insurance of citizens are not fiscally sustainable in spite of having fictitiously balanced balance sheets. The PIO Fund and the National Employment Service (NES) rely on the support of the Republic budget, while arrears of the Republic Health Insurance Fund (RHIF) to suppliers have reached the level of almost 10% of total annual expenditures of this Fund.

[15] Net effect which excludes the methodological changes that occurred in the Law on 2012 Budget, where a part of government expenditures thus far maintained as part of net budgetary lending is posted as subsidies.

In 2012, almost 50% of the PIO Fund revenues will come from the Republic budget transfers. Expenditures of the PIO Fund in 2012 will amount to around 564 billion dinars of which figure the transfers from the Republic budget will be about 278 billion dinars. The share of the transfers from the Republic in the revenues of the PIO Fund is increasing from year to year. Thus, the Republic will have to provide in 2012 additional 20 billion dinars against 2011 in order to enable the payment of pensions.[16] If revenues based on contributions from pension insurance fail to reach the figure from the plan, the Republic will have to also compensate this shortage to the Fund. The Fiscal Council notes that starting from 2012 military pensions of about 40,000 users will be paid through the PIO Fund and, therefore, this fact has to be taken into account at making year-over-year comparison of the PIO Fund expenditures.

The problem in operation of the Republic Health Insurance Fund (RHIF) is the large arrears. In analyzing the financial position of RHIF, it is necessary to take into account the large amount of arrears (not directly visible with the bookkeeping maintained based on cash flow principle). According to the last available data accessible to the Fiscal Council, RHIF is carrying over to 2012 the arrears worth about 20 billion dinars. Most probably, such high demands cannot be paid out in full amount during 2012 as they account for about 10% of planned RHIF revenues, so that their payment would require savings that are impossible to be achieved. Taking into account the fact that over the past couple of years the arrears have had an ascending trend, their payment in the course of 2012 is becoming even less probable. It is, therefore, necessary to consider a number of essential issues concerning this problem. First, it is necessary to investigate a possibility for RHIF and the Republic to reach an agreement with suppliers about the rescheduling of the claims and, second, it is necessary to dispel the dilemma as to whether these arrears are to be also formally treated as public debt since that they actually do represent the public debt.

The Fiscal Council has identified that expenditures of the National Employment Service are significantly reduced in 2012. Planned expenditures for NES amount to 34.3 billion dinars in 2012 (including all transfers), while in 2011 NES expenditures amounted to 35.3 billion dinars. However, a part of earlier expenditures of the Republic (Transition Fund) had been formally transferred to NES although the Republic is still financing these obligations by transfers.[17] For this reason, actual decrease of expenditures of NIS is about 5 billion dinars relative to last year. Essentially, by approximately the same amount the transfers of the Republic to NES are decreasing in 2012 relative to 2011 (when the Transition Fund is excluded). As the close of 2011, the trend of increased employment continues so that the decrease of expenditures to NES cannot be explained by economic developments. One of possible explanations is that the number of unemployed who receive assets from NES need not necessarily follow the trend of registered unemployed persons or the trend in the number of unemployed persons according to the economic definition of unemployment. Nominal decrease of expenditures for allowances to unemployed persons has been accompanied in the last two years by the growth of the

[16] The Fiscal Council excluded the impact of the shift of military pension payment to the PIO Fund, because from the angle of the Republic this change is neutral in terms of expenditures.
[17] Similarly as in the case of the shift to the PIO Fund of payments for military pensioners

rate of unemployment. The share of registered unemployed persons in the long run is very high so that one of the possible reasons for the decrease in NES expenditures is the decrease in the number of registered unemployed persons who are recipients of aid. Such a scenario may also be indicative of the fact that all planned NES expenditures, except for the transfers to households and transfers for the pension and health insurance of unemployed persons (which in total amount fall by about 5 billion dinars), are increasing or remaining at the same level as in 2011. The Fiscal Council holds that in the Report on Fiscal Strategy the decrease of expenditures of some budgetary beneficiaries needs to be substantiated in greater detail.

6. CONSOLIDATED DEFICIT AND FINANCING

Consolidated deficit in 2012 in the Report on Fiscal Strategy has been planned to be 4.25% of GDP or 152 billion dinars. Relative to 2011, nominal value of the deficit is almost unchanged but, when measured against GDP, the fiscal deficit decreased its share by about 0.25 p.p. It has been envisaged that public revenues register in 2012 a real growth by about 3.6% against 2011, and public expenditures by 2.7%, which will entail a moderate real decrease of consolidated deficit in 2012 by about 5%.

The Government has to provide for about 360 billion dinars in 2012 for repayment of the public debt principal. In this amount, the largest single item is the short-term public debt in the form of treasury bills denominated in dinars, which is about 230 billion dinars. Then follow “old” foreign exchange savings the funding of which requires about 35 billion dinars, while the remaining obligations based on repayment of the domestic public debt principal amount to about 55 billion dinars (30 billion is the existing domestic debt augmented by about 25 billion of the new public debt, which includes the debt to military pensioners, arrears of RHIF, etc.). The obligation for servicing the external debt principal is about 29 billion dinars, and the obligation for servicing the principal of guaranteed debts is about 11 billion dinars.

Total financial assets necessary to finance the fiscal deficit and the public debt principal are in 2012 equal to about 510 billion dinars (deficit of 152 billion and repayment of the public debt principal of 360 billion dinars). It will be possible to finance a part of the obligations in the amount of 50-60 billion dinars from the existing government foreign exchange deposits. Accordingly, it will be necessary to provide 450-460 billion dinars in 2012 for the financing of the fiscal deficit and due principals. The largest portion of the mentioned assets could be provided by the refinancing of due short-term debts under securities in the amount of 230 billion dinars. The remaining assets necessary to finance the fiscal deficit and due debts total 220-230 billion dinars. These assets will be partly provided by withdrawal of the tranches of the already contracted credits (infrastructure credits), and partly by the refinancing of due obligations and new borrowing. It has to be borne in mind, though, that the financing of the deficit influences the growth of the total public debt amount, while by refinancing one debt is replaced by another but the total debt amount does not change. However, debt refinancing requires trust on the side of investors and credit worthiness of the debtor, in this case the credit worthiness of the State of Serbia.

The Fiscal Council estimates that first problems in the Financing of the government's obligations may emerge as early as next year. The current wave of the public debt crisis in Europe has made investors distrustful and more cautious, so that they now react by rejecting to finance the public debt of a country with the debt level significantly lower against GDP than it was the case earlier. Accordingly, the largest current risk for Serbia is that investors assess at some point in time, which is not exactly foreseeable, that Serbia is insolvent and then decline to finance the fiscal deficit and repayment of due debts – which would mean the start of a debt crisis. Serbia is particularly vulnerable to the likelihood of investors' decision to desist from refinancing the securities, i.e. not to reinvest the assets due in treasury bills. The last relevant international analyses indicate that banks in the Euro zone, faced with the lack of liquidity, could start withdrawing the capital from the Central and Eastern Europe. In view of the instability in international environment as well as a possible distrust due to the high and increasing domestic public debt, decisions of the investors cannot be predicted in full and, accordingly, the risk of refinancing in 2012 is more pronounced than in the preceding period.

The assessment of the Fiscal Council is that due to the fact that the financing of obligations will be more difficult in the next year, the Government will not be able to respond by anti-cyclical fiscal policy to a possible worsening in economic trends. If in the next year tax revenues fall short of the plan due to lower economic growth, the Government will have two options. One option implies the tight control of the existing fiscal deficit regardless of the fall in revenues, while the second option directly or indirectly implies allowing of the fiscal deficit increase and ignoring the legal limit of 45% of GDP set for the public debt. The Fiscal Council holds that it is indispensable for the Government to limit in an organized manner (by control of the fiscal deficit) the growth of the public debt against GDP or otherwise the market will do it very easily instead of it by refusing to refinance the public debt of Serbia.

7. FISCAL FRAMEWORK FOR 2013 AND 2014

The Fiscal Council analysis shows the need for a decisive launching of comprehensive reforms that will lead not only to a decrease of public expenditures but also to a growth of public revenues as otherwise the public debt crisis is possible in the medium run. Because of the slow-down of the economic activity in 2011 and forecasted low real growth of GDP in 2012 of 1.5%, it is almost certain that the public debt will overshoot the legal limit of 45% of GDP and, if credible measures are not taken for curbing it, the pubic debt will go on growing in 2013 and in 2014. With such a trend of public debt growth Serbia will probably not only exceed the legal, but also the "economic" limit of the public debt after which investors will refuse to finance the existing public debt – or Serbia will enter the public debt crisis. It means that the fiscal policy in the medium term will have to be more restrictive than the one envisaged by the framework from the Report on Fiscal Strategy for 2013 and 2014. The Fiscal Council's analysis points to another even more unfavorable fact – that with the current fiscal policy it will not be possible to accomplish that insufficiently restrictive fiscal framework in 2013 and 2014. It is, therefore, necessary to launch comprehensive reforms urgently both on the side of expenditures and revenues.

The Fiscal Council holds that the macroeconomic framework from the Report on Fiscal Strategy is in accordance with the valid assumptions about the recovery of economic activities in Serbia and in Europe. As per estimate from the Report on Fiscal Strategy, the real growth of GDP in 2013 will be 3% and in 2014 at the level of 4%. The crucial factor which will lead to materialization of these growth rates is the beginning of the recovery of production already in 2012 (after the stoppage in the second half of 2011). Because of a possible escalation of the crisis in the Euro Zone, this assumption is still under a question mark. The Fiscal Council holds that the estimate of GDP in 2013 and 2014, based on the currently accessible data, is the best possible, but also exceptionally unreliable due to the great uncertainty awaiting us in 2012.

In the Report on Fiscal Strategy has been projected a drop of the fiscal deficit in 2013 to 3.7% of GDP, and in 2014 to 2.9% of GDP. The mentioned values of the deficit were obtained on the basis of the formula from the fiscal rules which defines the level of the permitted budget deficit. The assumptions that were used include: (1) fiscal deficit in 2012 will be 4.25% of GDP, and (2) real GDP growth in 2013 will be 3%, and 4% in 2014. It is noteworthy however, that according to the last Draft amendments and supplements of the Budget System Law, the fiscal deficit which arises from the fiscal formula (with more precision) is defined as the largest possible deficit of the general government. Therefore, the Fiscal Council holds that the fiscal deficit projections from the Report on Fiscal Strategy are in conformance with the fiscal rule relating to the budget deficit, but that there was also a possibility for planning an even lower deficit, which is necessary taking into account the need to reduce the public debt that will be above the legal limit of 45% of GDP, and bring it below that limit on a lasting basis.

The envisaged fiscal adjustment (i.e. reduction of fiscal deficit) in the medium run is taking place only through the side of expenditures. Draft Report on Fiscal Strategy envisaged the fiscal adjustment of a total of 1.7 p.p. of GDP (from 4.5% to 2.9% of GDP) in the period between 2011 and 2014 when such adjustment will mostly (1.6 p.p. of GDP) materialize through the reduction of public consumption, while no significant increase of public revenues has been planned. According to the plan from the Report on Fiscal Strategy, public revenues will increase relatively against GDP by 0.1 p.p. of GDP.

Medium-term level of public revenues is overestimated. Based on the projections of macroeconomic aggregates, including the expected changed in the structure of the economy, the existing tax system and the existing degree of tax collection, the Fiscal Council holds that the decrease of revenues in the 2012-2014 period (as a percentage of GDP) is underestimated. Instead of the projected cumulative increase of the share of revenues by 0.1 p.p. of GDP, more probable is their fall by about 0.5 p.p. of GDP.

VAT trends have been projected unrealistically. The projection of VAT based revenues shows that in 2013 and 2014 is expected a relative growth of these revenues against GDP when compared with 2011 and 2012 (Table 7.1.). because of the expected rebalancing of the economy in the direction of a larger share of exports and investments and a smaller share of consumption, the Fiscal Council believes that the mentioned trends are little probable. Namely, it believes that the VAT/GDP ratio will decrease in the period until 2014 (by 0.6 p.p. of GDP), rather than increase as envisaged in the Report on Fiscal Strategy.

Other tax revenues have been assessed realistically. Most tax revenues generally keep their share in GDP at the level from 2012 (personal income tax, corporate profit tax, excise duties, other tax revenues and contributions – Table 7.1.). Taking into account the pronounced relative fall in revenues from the tax on the profit of crisis affected companies, it is probable that their share in GDP will in the medium run, after overcoming the crisis, go up slightly. It is for this reason possible that the projections from the Report on Fiscal Strategy slightly underestimate the revenues from corporate profit tax. The share of customs tariffs revenues in GDP is falling as a consequence of further foreign trade liberalization, while after the high growth in 2012 due to one-off measures for increase of non-tax revenues (claim collection from bankruptcy estate), the share of non-tax revenues in GDP will return to its usual level already starting from 2013.

Table 7.1. Projected Public Revenues of the Republic of Serbia, in 2012–2014 Period

	Share in GDP (%)		
	2012	2013	2014
PUBLIC REVENUES	39.9	39.4	39.2
Current revenues	39.8	39.3	39.2
Tax revenues	34.1	34.1	34.0
Personal income tax	4.5	4.5	4.5
Corporate profit tax	1.2	1.2	1.2
Value added tax	10.2	10.4	10.5
Excise duties	5.4	5.4	5.4
Customs tariffs	1.0	0.8	0.7
Other tax revenues	1.3	1.3	1.3
Contributions	10.5	10.5	10.5
Non-tax revenues	5.7	5.2	5.1
Capital revenues	0.0	0.0	0.0
Donations	0.1	0.0	0.0
Real DP growth (%)	**1.5**	**3.0**	**4.0**

The Report on Fiscal Strategy foresees that medium-term adjustment of the budget deficit be carried out by the decrease of the share of public expenditures in GDP. Table 7.2 presents the share of public expenditures in GDP in the 2012-2014 period. It can be seen that the share of public expenditures dropped in the mentioned period by more than 2 p.p. of GDP, namely, by 1.1 p.p. of GDP in 2013 and by 1 p.p. of GDP in 2014.

Further sharp reduction in subsidies, expenditures for goods and services and net budgetary lending has been planned. The largest expenditure items – pensions and wages in the public sector – are defined by the fiscal rules and their share in GDP is gradually falling, which is correctly projected in the Report on Fiscal Strategy. However, this decrease will not be sufficient to ensure the necessary adjustment of the budget expenditures, and thus the Report on Fiscal Strategy envisages sharp decrease in the share of certain expenditure items in GDP in medium term (Table 7.2.). This principally relates to the allocations for the purchase of goods and services (decrease of 1.1 p.p. of GDP) and subsidies (decrease of 0.5 p.p. of GDP). The envisaged trend of net budgetary lending indicates that its small share in GDP from 2012 will be maintained. The assessment of the Fiscal Council is that it will be very difficult to accomplish such large savings. The analysis of projected public expenditures in 2012 has already raised the dilemma with regard to the realistic possibility of materialization of those plans. The fiscal framework which assumes continuation of similar trends also in the next two years is deemed to be even less probable. The Fiscal Council also has certain reservations with respect to estimated trends in allocations for interest payments. Namely, in 2012 has been planned a growth in the share of allocation for interest payments in GDP to 1.8% against 1.4% of GDP in 2011. The medium-term fiscal framework involves a sharp braking of this growth which, according to the Fiscal Council, is little probable when the share of public debt in GDP is rising, but also is rising the share of credits with the high interest rate in the overall government debt.

The proposed structure of public expenditures, even if materializes, cannot be evaluated by the Fiscal Council as desirable for accomplishment of the fiscal and development policies, because the level of capital expenditures does not correspond to the development needs of the country. The assumed budgetary framework does not leave enough room for the growth of capital expenditures. Only in 2012 is envisaged a real growth of capital expenditures larger than the growth of GDP and increase of their share in public expenditures, whereas the trend in 2013 and in 2014 is unfavorable, both in terms of growth (in 2013 is even envisaged a real fall) and their share in public expenditures. Such a trend of capital expenditures is cont in conformance with the development needs of the country and the imperative to have the small share of capital expenditures increase in the structure of public expenditures.

Table 7.2. Projected Public Expenditures of the Republic of Serbia in 2012–2014 Period

	Share in GDP (%)		
	2012	2013	2014
PUBLIC EXPENDITURES	**44.2**	**43.1**	**42.1**
Current expenditures	40.0	38.9	38.0
Expenditures for employees	10.2	10.0	9.8
Purchase of goods and services[1)]	7.3	6.6	6.2
Interest repayment	1.8	1.9	2.0
Subsidies	2.7	2.3	2.2
Social welfare and transfers	18.0	18.2	17.8
Capital expenditures	4.0	3.8	3.8
Net budgetary lending	0.2	0.3	0.3
Real GDP growth (%)	**1.5**	**3.0**	**4.0**

[1)] Purchase of goods and services also covers other expenditures according to IMF methodology

The projection of public debt level of general government is not adequate in the draft Report on Fiscal Strategy. According to the projections presented in the draft Report on Fiscal Strategy (in Table 33), the public debt of general government is immediately below the limit of 45% of GDP in the next three years. In connection with these projections, two problems are discerned. First, the public debt has been projected according to special methodology (the so-called Maastricht Criteria) which is not compliant with the laws applicable in the Republic of Serbia since the said methodology excludes non-activated guarantees of the Republic from the public debt. As according to the Public Debt Law and the Budget System Law public debt includes all guarantees (regardless of whether activated or not), then the public debt projection must include the non-activated guarantees. Accordingly, the projected values of the public debt would in the draft Report on Fiscal Strategy be larger if the methodology of public debt capture from applicable laws were applied. It is, therefore, necessary to project the public debt in the Report on Fiscal Strategy in accordance with domestic legislation. Second, in making the public debt/GDP projection needs to be explicitly mentioned the assumption based on which the projections were made, and which relate to the trends of: primary fiscal deficit, real interest rates in dinars and foreign exchange (domestic and foreign), shares of FX and dinar debts in the public debt, and expected changes of the real exchange rate. In Table 33, apart from the data relating to the total fiscal deficit, the only additional data shown are those which refer to primary fiscal deficit. The listed assumptions and accompanying substantiations would allow broader public to consider the realisticity of the projected public debt/GDP ratio.

In the medium run, the public debt will remain above the level of 45% of GDP; therefore, a plan of responsible finance management is necessary both in the short and long run. Taking into account the macroeconomic framework and fiscal trends in 2013 and 2014, the public debt will remain in excess of the limit of 45% of GDP. The budget System Law has defined two general fiscal rules which relate to the fiscal deficit and the level of the public debt. According to the Budget System Law, the Government has a duty to define the measures for public debt reduction if it surpasses 45% of GDP. Bearing in mind the fact that in the future three-year period the public debt will most probably be above the upper limit, the Government needs to prepare a program for public debt management. Apart from moderate fiscal consolidation which is feasible thanks to the fiscal rule about the general government deficit, additional measures are also necessary in order for the public debt to remain under control and avoid disruption of the fiscal and financial stability of the state.

If achievement of the fiscal adjustment proves to be impossible under the assumptions from the Report on Fiscal Strategy, the view of the Fiscal Council is that fiscal adjustment over the medium term is indispensable. In order for the trend of fiscal deficit to reverse, the cut of fiscal deficit needs to be even steeper than the one envisaged by the Report on Fiscal Strategy. The Fiscal Council’s analysis points to another unfavorable conclusion – even the planned, insufficient fiscal adjustment will not be achievable because the public revenues will be smaller and public expenditures larger than the plan. The Fiscal Council holds that the Government needs to urgently adopt the plan and start implementing the reforms of public expenditures and public revenues.

According to the Fiscal Council, a lasting sustainability of public finances requires fiscal adjustment in the medium run by about 4.5 to 5 p.p. of GDP. The Fiscal Council has analyzed the fiscal adjustment necessary for reaching the targeted deficit of 1% of GDP over the medium term. Starting from its own projections of public revenues (which are lower than those from the Report on Fiscal Strategy by 0.6 do 0.7% of GDP) and the need that the share of public investments goes up by about 0.7% of GDP (from planned 3.8% of GDP to 4.5% of GDP), the Fiscal Council's assessment is that medium-term fiscal adjustment by 4.5 to 5% of GDP is necessary. Such a large fiscal adjustment is possible only on the basis of the essential reforms of public finances.

The Fiscal Council believes that the bulk of fiscal adjustment needs to be ensured by the reduction of current public expenditures. The estimated share of public expenditures in GDP of about 44.2% of GDP in 2012, of which current public expenditures account for more than 40% of GDP, is very high. It is therefore believed that the key strategic determination of the government needs to be a lasting decrease of the share of total public expenditures in GDP, and that possible upward adjustment of public revenues needs to be significantly smaller. The time period in which current expenditures need to be reduced represents additional limitation since the Fiscal Council's assessments point to unsustainable growth of the public debt if fiscal adjustment does not commence as early as possible.

The Fiscal Council's opinion is that a comprehensive plan of the public sector reforms needs to be prepared in 2012 and that legal regulations need to be changed in accordance with such plan. As more than 70% of expenditures is determined by law and obligations, the Government's maneuvering space for possible savings is small in the short run. However, if preparation of credible reforms starts right away and if the existing laws are amended on that basis in the next year, it is possible to improve efficiency of the public sector in the medium term and adjust the overall public consumption with economic possibilities of the country. Timely systemic decrease of public consumption against GDP would crucially contribute to the prevention of debt crisis. Sufficient savings on the position of current expenditures can only be achieved by systemic structural reforms targeted to the largest expenditure items of the budget: pension reform, reform of the health and education sectors, rationalization of the public administration, establishment of a sustainable fiscal decentralization system, and rationalization of public enterprises.

A comprehensive tax reform which will have a positive impact on the growth of public revenues will probably also be necessary. During the previous several years, despite the fact that the most important tax rates were not changed, the share of public revenues in GDP has fallen. It was the result of the change in the structure of economy on account of decrease in consumption. Taking into account that similar trends will probably continue in the future as well, the Fiscal Council is of the view that it is necessary to launch a comprehensive tax reform which will by all its effects lead to the growth of public revenues. It is estimated that only the increase of VAT can satisfy the estimated needs from the point of view of public revenues increase, which can also be accompanied by certain decrease of the tax burden on labor. The mentioned changes would in addition to fiscal implications also have a significant positive impact on the improvement of the business ambiance.

8. ANALYSIS OF THE REPUBLIC 2012 BUDGET

The Republic budget is adjusted with the fiscal rules and confirmed by the agreement with the IMF. Budget revenues are projected at about 750 billion dinars, budget expenditures at about 875 billion dinars while the deficit of the Republic is around 125 billion dinars. When expenditures under project loans are also added up (about 15 billion dinars) the expenditures of the Republic total about 890 billion dinars and the deficit is around 140 billion dinars. As mentioned in Section 2, the Republic deficit of 140 billion dinars is envisaged within the deficit of consolidated general government of about 152 billion dinars (4.25% of GDP) and is in accordance with the fiscal rules.

Table 8.1. Republic of Serbia Budget, 2011 and 2012 (in thousand dinars)

	Budget 2011	Budget 2012	Difference (2012-2011)
TOTAL REVENUES AND EARNINGS OF THE REPUBLIC	**707,345,000**	**750,100,000**	**42,755,000**
1. Tax revenues	657,845,000	678,200,000	20,355,000
1.1. Personal income tax	71,100,000	42,300,000	-28,800,000
1.2. Corporate profit tax	35,100,000	39,400,000	4,300,000
1.3. Value added tax	341,355,000	362,800,000	21,445,000
1.4. Excise duties	161,625,000	191,000,000	29,375,000
1.5. Customs tariffs	39,765,000	34,000,000	-5,765,000
1.6. Other tax revenues	8,900,000	8,700,000	-200,000
2. Non-tax revenues	49,500,000	71,900,000	22,400,000
TOTAL EXPENDITURES OF THE REPUBLIC	**850,091,802**	**875,293,647**	**25,201,845**
Current expenditures	801,227,266	844,028,190	42,800,924
Expenditures for employees	204,129,428	218,827,612	14,698,184
Purchase of goods and services	47,589,354	46,593,057	-996,297
Interest repayment	42,111,729	59,197,670	17,085,941
Subsidies	54,309,353	62,337,444	8,028,091
Transfers to obligatory social insurance organizations	280,074,899	290,479,231	10,404,332
- Republic Pension and Disability Insurance Fund	238,100,000	278,400,000	40,300,000
Other grants and transfers	1,318,002	1,286,714	-31,288
Social welfare from the budget	91,540,871	86,112,248	-5,428,623
Other current expenditures	13,642,160	10,425,091	-3,390,569
Capital expenditures	23,348,650	22,548,600	-800,050
Expenses for procurement of financial assets	25,515,885	8,716,857	-16,799,028
DEFICIT OF THE REPUBLIC	**-142,746,803**	**-125,193,647**	**17,553,156**
On revenues and donations	81,140,235	71,247,062	9,893,173
Expenditures financed from own revenues	72,140,235	71,247,062	893,173
DEFICIT OF THE REPUBLIC WITH OWN REVENUES, WITHOUT EXPENDITURES FOR PROJECT LOANS	**-133,746,802**	**-125,193,647**	**8,553,155**
Project loans	6,100,000	15,500,000	9,400,000

DEFICIT OF THE REPUBLIC WITH OWN REVENUES AND EXPENDITURES FOR PROJECT LOANS	**-139,846,802**	**-140,693,647**	**-846,845**

Budget revenues are unchanged in real terms against the past year. Revenues of the Republic budget are in accordance with the Budget Law larger by 43 billion dinars against the past year, which corresponds to real growth of about 2%. However, real growth of public revenues is smaller. Namely, the Republic is simultaneously with certain new revenues also getting new liabilities. Thus, together with the revenues from excise duty on fuel, the obligation was assumed to subsidize JP „Putevi Srbije“ in the amount of 8.8 billion dinars, so that net increase of the Republic budget revenues is smaller. Also, through the republic budget is posted the solidarity transfer which is composed of 10 percentage points of the collected personal income tax surrendered by the City of Belgrade. Such assets are only formally the income of the Republic because they are immediately transferred to the local self-government. When these two items are deducted from the revenues of the Republic budget, the Republic budget does not actually have in 2012 the real growth of revenues against 2011.

The decrease in the Republic revenues in favor of the local self-government has created a shortage in public revenues. In relation to the revenues in the revised 2011 budget, a fall was projected in the personal income tax by about 29 billion dinars (due to the application of the amended Law on Local Self-Government Financing). The largest increases are expected in the case of excise duty (29 billion dinars, the largest effect based on excise duty that once used to belong to JP „Putevi Srbije“), non-tax revenues (22 billion dinars, inflow from bankruptcies) and value added tax (21.5 billion dinars). There is a strong risk that revenues from value added tax in 2012 could be smaller than projected.[18]

The Fiscal Council has detected two opposing trends in the movement of public expenditures: the growth in allocation for pensions, wages and interests and a sharp decrease in discretionary expenditures. Budget expenditures are relative to 2011 larger by about 25 billion dinars. Relative to budget expenditures in the revised 2011 budget, growth of expenditures for pensions and wages has been projected by about 30 billion dinars and for interests by 17 billion dinars, while the sharpest decline, by 17 billion dinars, has been envisaged in the case of expenses for the procurement of financial assets (net budgetary lending). Smaller expenditures in relation to the level from 2011 have also been planned in capital expenditures (by 800 million dinars) and procurement of goods and services and other current expenditures (by slightly more than 4 billion dinars). Such trend of public expenditures is mostly in accordance with the projections as contained in the Report on Fiscal Strategy.[19] Some dissentions, principally in the case of subsidies, will be discussed in greater detail further in the text.

Planned growth of expenditures for wages and pensions is in conformance with the Budget System Law, and the growth of interests is in conformance with the contractual obligations of the Republic. The growth of expenditures for pensions, wages and interests had been practically pre-defined and it was practically not possible to influence

[18] See Section 3 for more details about the evaluation of public revenues in 2012
[19] See Section 4 for evaluation of public expenditures in 2012

on it during the budget planning. Increase in expenditures for pensions and wages in the public sector arises from the application of fiscal rules in connection with indexation of pensions and wages in the public sector, while interests are projected according to scheduled public debt maturities.

The Fiscal Council assesses that there are certain risks of projected allocations for social allowance smaller than the needs. Expenditures for social welfare are nominally equal to the planned expenditures in 2011. The difference between the expenditures for social welfare in 2012 and in 2011 of about 5.5 billion dinars (Table 8.1) arises from the change in the classification of the Transition Fund item which was in the 2011 budget posted as compensation for social welfare and in the 2012 budget is posted as grants to organizations of obligatory social insurance. Expenditures for social welfare in 2012, such as for child allowance, veteran-disability allowances, social welfare, pupil standard and student standard, refugees and dislocated persons – remain on approximately the same level as in 2011, both in aggregate and individually. The Fiscal Council deems, with certain risks, that the level of allocations for these purposes may be sufficient for the listed social purposes in 2012. Namely, in 2011 will for these purposes be spent two to three billion dinars less for these purposes than planned by the revised budget. Therefore, although the allocations for social purposes appear unchanged in relation to the revised 2011 budget, these expenditures will actually rise relative to those to be really realized in 2011.

A marked fall in discretionary expenditures has been projected which might not materialize in full. Subsidies and net budgetary lending (government credits) would need to be in 2012, according to the projected values, by about 9 billion dinars smaller when compared with 2011. Also are envisaged substantial savings in public procurements (purchase of goods and services and other current expenditures). There are risks of non-materialization of the mentioned ambitious plan since the envisaged reductions in the mentioned expenditures are sharp and the danger of non-realization of expenditures because of the shortage of available assets, i.e. the danger of increase in the government arrears.

Capital investments of the Republic are rising when project loans are included in them and when it is taken into account that a part of investments of local character, implemented by the former Ministry for NIP, has been shifted to the local government level. There are no increased allocations from the Republic budget (by narrower definition) for investments in relation to the revised 2011 budget. However, project loans register a high growth in 2012 relative to the preceding year (from slightly more than 6 billion dinars to 15 billion dinars). Also, certain investments earlier implemented by the Ministry for NIP are now the obligation of the local government level (5-7 billion dinars). For this reason, the Fiscal Council assesses that the investments of the Republic actually have a rising trend relative to a year ago. This assessment is to some extent relativized by the fact that the by the revised 2011 budget capital expenditures of the Republic were lowered by about 8 billion dinars relative to the original budget. Taking all of the above into account, the Fiscal Council concludes that the public investments trends in the Republic 2012 budget are approximately in accordance with the trend of investment growth at the general government level (see Section 4 for more details).

It is the good news that the government assistance to the economy is decreasing through subsidies and lending, but the question is whether the ambitious plan of savings will fully materialize. Expenditures for subsidies and net budgetary lending are in the 2012 budget smaller than in the revised 2011 budget by about 9 billion dinars. At the same time, subsidies were increased by 8 billion dinars and net budgetary lending decreased by 17 billion dinars. The increase of subsidies results from methodological changes in the budget rather than from actual increase of subsidized assets for the economy. First, it is for the first time that subsidies for roads appear in the budget (8.8 billion dinars) as the consequence of the changes in the collection of excise duties and, accordingly, of the mode of financing of the JP „Putevi Srbije“. If this new budget item were excluded, subsidies would be by about one billion dinars smaller than in 2011. Second, some expenditures were earlier posted as net budgetary lending and are currently accounted for as subsidies (the issue of subsidized loans for liquidity and investments of special significance – FIAT). As the capture has been changed, the sum of expenditures for subsidies and net budgetary lending is not directly comparable with that of last year. Instead, they have to be viewed by individual items. Subsidies for the railways would need to be reduced by 3 billion dinars (from 16 to 13 billion)[20], subsidies to the economy by one billion, subsidies to public companies are also smaller by one billion dinars, subsidies in tourism by 200 million dinars, while subsidies in culture are smaller by 120 million dinars. On the other hand, it was planned to keep in the Republic budget the subsidies for agriculture at almost the same level as in 2011 (around 20 billion dinars). The novelty in the 2012 budget is that subsidies of 1.5 billion dinars are envisaged to private financial institutions for settlement of the obligations arising from the implementation of the Decree on the Conditions and Criteria for Subsidizing Dinar Cash Credits for Spurring Domestic Demand. Also, recapitalization of Komercijalna banka has been envisaged in the amount of 11.5 billion dinars (these assets remain „below the line“ and do not increase the budget deficit) for the purpose of preserving the proprietary interest of the Republic in this bank.

Changes in expenditures per ministries can mostly be explained by formal factors and completion of multiyear projects. However, in some cases were also identified the changes with lasting implications on budget expenditures. Overview of the expenditures per budgetary beneficiaries reveals that when comparing with the 2011 revised budget the largest decrease in expenditures is in the case of the Ministry of Defense whose expenditures are smaller by about 21 billion dinars. However, this difference is the consequence of methodological (and not substantial) changes, i.e. the fact that military pensions were in 2011 posted as grants from the Ministry of Defense (which had increased the Ministry of Defense expenditures), and that starting from 2012 the pensions will be paid from the PIO Fund. The budget of the Ministry of Economy and Regional Development was cut by about 13 billion dinars as the consequence mostly of the completion of the largest portion of allocations for government investments in the company „Fiat automobili Srbija" and some other projects implemented through this Ministry. Expenditures were increased in the Ministry of Interior (by about 4.5 billion dinars). The growth of expenditures of this Ministry arises from higher wages of the police officers in 2012 (by about 5.8 billion dinars), which is the consequence of the

[20] They are practically made to be subsidies for the wages of this public company's employees.

amended Law on Police.[21] A rise of expenditures is also planned in the Ministry of Infrastructure and Energy (by about 5 billion dinars), and the reason is that the mentioned subsidies to JP „Putevi Srbije“ will be implemented through the chapter of the Ministry of Infrastructure and Energy.

Pronounced risk of the spending of own budgetary beneficiaries' revenues getting out of control. A large part of public administration: ministries, funds, directorates, institutes, etc. generate their own revenues from different fees, stamp duties, fines and similar sources. The analysis made by the Fiscal Council has found that the manner in which these assets are used, and also their presentation in the Budget Law, is not in accordance with the good practice of public finances management, and that it can have an adverse impact on accomplishment of the fiscal objectives in 2012. It was emphasized in Section 5 that in parallel with the cuts in the Republic budget expenditures is projected a high growth of spending (by about 20% in real terms[22]) of own budgetary beneficiaries' revenues. At the same time, apart from own revenues which the budget beneficiaries generate throughout the year (71 billion dinars projected as can be seen also in the basic Table 8.1), the sources for their additional revenues are multiple: unspent revenues from the preceding year, donations from various domestic and foreign sources, borrowing in the country and abroad, sale of property, etc. In the 2012 budget, the projected framework for additional revenues of budgetary beneficiaries (136 billion dinars) is almost twice as large as own revenues (71 billion dinars). Although it is well known from practice that a broad framework for budgetary beneficiaries' expenditures is determined by budgeting (in other words: not all financial sources projected by the budget are spent during the year), the Fiscal Council is of the view that budget beneficiaries' own and external assets are given an opportunity that the spending of budget beneficiaries gets out of control. If the spending based on budgetary beneficiaries' own revenues increases over 71 billion dinars, i.e. above the revenues planned by consolidated budget, then the deficit will also in the same amount overshoot the upper permitted level.

The Fiscal Council expresses concerns over the fact that by the shifting to the financing from own revenues some ministries circumvent the limitations at planning the budget. Transparency of the Republic budget is impaired by inadequate budgetary presentation of the sources and spending of own revenues of budgetary beneficiaries. The most important cumulative budget tables (presented in Article 1 of the Budget Law) are defective due to the fact that they only present the expenditures of the Republic budget in narrower sense. In other words, the expenditures funded from own and other additional sources of budgetary beneficiaries are not presented. As a result, non-transparent public finances and economic policy arise from such tables. Interpretation of the projected expenditures of some ministries is more difficult, and also erroneous, if expenses that will be financed from the funds and agencies under their competence are not taken into account. The Ministry of Agriculture, Trade and Water Economy is the ministry under the auspices of which the largest amount of own revenues is generated. In 2012, apart from 23 billion dinars of assets planned from the Republic budget (approximately the same amount as in 2011), additional resources of budgetary

[21] For assessment of the fiscal effects of the Law Amending and Supplementing the Law on Police, see Fiscal Council's separate analysis accessible on the Fiscal Council's Internet web page.

[22] According to the methodology used in the Report on Fiscal Strategy

beneficiaries of as much as 26 billion dinars were projected as additional assets of budgetary beneficiaries. Besides the subsidies of about 20 billion dinars from the Republic budget (also presented in the Table in Article 1 of the Budget Law), it was projected that from additional sources of budgetary beneficiaries under the auspices of the Ministry of Agriculture, Trade and Water Economy be financed additional subsidies worth more than 15 billion dinars. Even more drastic is the situation with the Ministry of Environment, Mining and Spatial Planning for which is planned slightly more than 5 billion dinars of budget assets in 2012, but also more than 12 billion dinars of additional assets of budgetary beneficiaries (agencies and funds) which are under the auspices of this Ministry. The view of the Fiscal Council is that it may be advisable to join the said funds and agencies with the competent ministries, to reconsider the need for the existence and the level of different quasi fiscal imposts from which these funds are financed, but also the possibility of a larger budgetary disposal of assets gathered in this manner.

Negative consequences of non-transparent budgetary framework are multiple, and already in 2012 the deficit of general government may exceed by 0.5 percentage points the limit of 4.25% of GDP if uncontrolled spending of own revenues of budgetary beneficiaries occurs. The above discussion shows that inadequate treatment of budgeting, reporting and spending of own and other additional revenues of budgetary beneficiaries have several consequences. First, the expenditures and deficit of general government can overshoot the planned limits in spite of savings and control at the narrower Republic level, in which way the process of fiscal consolidation at the central government level will become meaningless. The Fiscal Council's assessment is that the high spending of own budgetary beneficiaries' revenues in the next year can contribute to the growth of deficit by up to 0.5 percentage points in excess of the limit of 4.25% of GDP. Second, it is not possible to get a clear picture of the assets that ministries dispose of during the year – clearly are presented only the assets that are received from the budget, but not also own and other additional assets of budgetary beneficiaries (they are sometimes several times larger than budgetary assets). Third, the economic policy which is pursued is unclear – the structure of public expenditures (primarily that of subsidies) – can be completely seen only if own revenues are transparently integrated in the budgeting process. Fourth, spending of own budgetary beneficiaries' revenues cannot be reliably monitored during the year in view of the fact that a broad framework is randomly left for their spending, on the one hand, with unreliable control mechanisms (arising from the legal and factual autonomy of budgetary beneficiaries), on the other. Fifth, further impairment of the principle of public finance transparency is possible: incentives are rising for establishment of special budgetary beneficiaries (funds and agencies) that will be able to ensure sufficient assets for the desired expenditures of competent ministries. Sixth, the bifurcated system of autonomous budgetary beneficiaries leads to increasingly high parafiscal imposts (various duties and fees), thus increasing the fiscal burden of the economy and citizens and derogating the fiscal system of the Republic.

A plan of guarantees also involves the guarantees for overcoming the problems of current liquidity. In the Draft Law on Republic of Serbia 2012 Budget are noticed the guarantees to commercial banks for the borrowing of the public company „Srbijagas". General envisaged amount of guarantees to commercial banks for the borrowing of this company in 2012 is almost 70 billion dinars of which amount 40 billion dinars relates to this company’s borrowing for maintenance of current liquidity. Government guarantees are justified in the cases of borrowing for capital projects which, as a general rule, are implemented with the participation of and control by international financial institutions. Borrowing of a public company from commercial banks for the purpose of maintaining current liquidity does not have the features of a development credit. Apart from the fact that each issued guarantee increases the debt of the general government, as defined in the Budget System Law, it is necessary to take into account that the value of a new debt and guarantees is one of the performance criteria of the current arrangement with the IMF.

The borrowing plan points to the likelihood of unplanned increase of government expenditures, additional pressure on the public debt and worsening of the problem of financing. The borrowing plan of the Republic of Serbia in 2012 presented in the Draft Budget Law also envisaged the borrowing for regulation of the debt of obligatory social insurance organizations and preservation of financial stability (45 billion dinars), as well as for urgent interventions from commodities reserves (10.5 billion dinars). The mentioned government borrowings have multiple potential negative consequences. First, they can result in unplanned increase of public expenditures and rise of deficit above the permitted limit. Second, the borrowing accelerates the growth of the public debt because new credits are added to the earlier contracted project loans. Three, government needs for new financial assets additionally increase in the presence of the already mentioned uncertainty in terms of acquiring the necessary financial assets (510 billion dinars) under earlier borrowing and budget deficit (see Section 6 for more details about the danger of escalation of the funding problem).