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SERBIA: TWO YEARS OF FISCAL CONSOLIDATION – RESULTS AND MEDIUM-TERM SUSTAINABILITY ISSUES*

Srbija: Dve godine fiskalne konsolidacije – rezultati i pitanja srednjoročne održivosti

Abstract

Fiscal consolidation in Serbia was based on a comprehensive, multi-year program built on broad-based expenditure cuts, better revenue performance, and related structural reforms and pro-growth policies. During the first two year of implementation the actual fiscal performance substantially exceeded the original and revised deficit targets set in the IMF supported three-year precautionary program. In 2015, the actual deficit (3.7 percent of GDP) exceeded program target by 2.2 percentage points. In 2016 the implementation performance further improved as the actual deficit (1.36 percent of GDP) was 2.6 percentage points better than the plan. The result implies a 4.4 percentage point structural deficit adjustment which exceeds the program target one year ahead of schedule. In this, revenues contribute 3.5 percentage points, public wages 1.0, pensions 0.6 and reversals of structural expenditure savings take away -0.7.

The program had a beneficial impact on economic growth. The economy bottomed-out in the third quarter and started recovering in late 2014-early 2015 leading to a positive 0.8 percent growth for the entire year. The growth further recovered in 2016 (+2.8 percent) and is expected to reach 3 percent in 2017 and stabilize at 3.5 percent annually thereafter. With this performance Serbia may become a case of "expansionary austerity" which demonstrates that fiscal consolidation programs designed in line with sound principles and synchronized with key structural reforms and pro-growth policies can generate growth. Carefully selected expenditure cuts combined with pro-growth revenue collection efforts can have expansionary effect on growth even under most difficult circumstances.

The political economy issues of fiscal consolidation and structural reforms gain increasing importance in the last year of the program, two months ahead of presidential elections. Fresh thinking is needed to demonstrate that the completion of difficult reforms is a win-win for all, and most everybody loses if reforms are stalled or abandoned.

Keywords: *fiscal consolidation, fiscal deficit, fiscal stimulus, public debt, structural reforms, austerity, contractionary fiscal policy, expansionary fiscal policy, economic growth, expenditure cutting measures, revenue enhancing measures*

Sažetak

Program fiskalne konsolidacije u Srbiji zasniva se na sveobuhvatnom programu smanjenja rashoda, povećanju budžetskih prihoda i povezanim strukturnim reformama i politikama koje podržavaju ekonomski rast. Tokom prve dve godine programa ostvareni fiskalni rezultati prevazišli su originalne i revidirane ciljeve postavljene u MMF programu. U 2015. stvarni deficit (3.7 posto BDP) prebacuje cilj za 2.2 procentna poena. U 2016 realizacija je dalje unapređena tako da je stvarni deficit (1.36 posto BDP) bio za 2.6 procentnih poena bolji od plana. Ovaj rezultat sadrži strukturno poboljšanje deficita od 4.4 procentnih poena čime se prebacuje cilj programa godinu dana pre roka. U tome, prihodi doprinose 3.5 procentna poena, plate u javnom sektoru 1.0, penzije 0.6 a povecanje rashoda oduzima -0.7.

Program je dobro delovao na ekonomski rast. Pad je preokrenut u trećem kvartalu i oživljavanje je krenulo krajem 2014 i početkom 2015 tako da je za celu godinu ostvaren rast od +0.8 posto. Rast se dalje oporavio tokom 2016 (+2.8 posto), očekuje se da bude 3.0 posto u 2017. i da se stabilizuje na oko 3.5 posto nakon toga. Ovakvim performansama Srbija može da postane primer tzv. "ekspanzivne štednje" koji pokazuje

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da programi fiskalne konsolidacije napravljeni na zdravim ekonomskim principima i sinhronizovani sa važnim strukturnim reformama i politikama mogu da generišu ekonomski rast. Pažljivo odmeravanje smanjenja rashoda kombinovano naporima za povećanje prihoda mogu da imaju pozitivno dejstvo na rast čak i u najtežim uslovima.

Pitanja političke ekonomije programa fiskalne konsolidacije i strukturnih reformi dobijaju na značaju u drugoj godini programa, a posebno nekoliko meseci pred vanredne parlamentarne izbore. U tom kontekstu potrebno je kreativno razmišljati kako da se javnosti objasni da završetak teških i već započetih reformi predstavlja dobitnu kombinaciju za sve, dok gotovo svi gube ukoliko reforme budu zaustavljene ili napuštene.

Ključne reči: *fiskalna konsolidacija, fiskalni deficit, fiskalni stimul, javni dug, strukturne reforme, štednja, restriktivna fiskalna politika, ekspanzivna fiskalna politika, ekonomski rast, mere za smanjivanje rashoda, mere za povećanje prihoda*

Introduction – Recent history of IMF supported programs in Serbia

In the post-October 2000 period Serbia has had a series of stabilization, adjustment, economic reform, and crisis response programs supported by the IMF.

First Stand-By Arrangement (June 2001 – June 2002). Following a short post-conflict program implemented between December 2000 and March 2001, the first Stand-By Arrangement was approved in June 2001 with an aim of supporting the authorities in "… establishing market confidence, building broad support for reform, and ensuring its sustainability" … while allowing them "… to adhere to prudent macroeconomic policies, advance economic restructuring, and intensify efforts to catalyze external assistance, including debt relief". Given the difficult initial conditions burdened by a decade of sanctions, wars and economic destruction, significant progress was made in achieving program targets in reducing inflation, stabilizing the exchange rate, strengthening the foreign reserve position, and recovering output [28, p. 6].

Net domestic assets and public sector wages were the main nominal anchor under the program. A crawling peg regime provided a "visible" nominal anchor and helped reinforce disinflation through an ex ante defined rate of crawl. The immediate fiscal consolidation hinged on reduced monetization of fiscal and quasi-fiscal deficits enabled through greater revenue effort, increased foreign assistance, debt relief, and initial privatization receipts. This was supplemented by a standard set of structural reforms targeting revenue administration, bank restructuring and resolution, privatization of state enterprises and utility companies, and trade liberalization.

Extended Arrangement (April 2002 - February 2006). New three-year arrangement was signed in April 2002 to secure continuity of macro-policies and structural reforms as a basis for sustained growth and confidence levels of Paris and London club creditors. Initially, the EA program based on a quasi-peg exchange rate regime was successful in lowering inflation and strengthening GDP growth based on strong aggregate demand.

At the end of the first program year it became clear that structural reforms will face challenges in the medium run. Enterprise restructuring programs met immediate resistance from the unions and interest groups, further exacerbated by the apparent lack of fiscal resources needed to mitigate the social impact. At the same time strong capital inflows, grants, and remittances fueled already buoyant domestic demand. This led to inflationary pressures (especially in non-tradeables), widened external imbalances and undermined exchange rate based stabilization [34, p. 9]. As a result both the inflation and CAD targets were missed. Economic growth improved but turned out to be unsustainable both in terms of large external deficits and weak domestic supply response due to lagged privatizations and enterprise restructuring programs.

The program was extended twice, for almost a year (from May 2005 to February 2006), to enable the authorities to meet the macro and structural targets set in the program.

The emergence of vulnerabilities (February 2006 – December 2008). During the 2006-2008 period GDP continued to grow at close to 6% per annum based on domestic aggregate demand (absorption) financed predominantly from external sources. Albeit impressive, this growth could not be sustained since it generated growing current account deficits (from 9.6% in 2006, via 18.6% in 2007, to 21.1% in 2008) caused by high import dependence, required ample external financing, and induced weak domestic supply response mainly in non-tradeables. These vulnerabilities turned into binding constraints soon after the global financial crisis broke out in September 2008 and the authorities requested a new stand-by program.

Second Stand-By Arrangement (January 2009 – April 2011). Despite early announcements that Serbia is well prepared to handle the global financial crisis, already in November 2008 Serbian authorities requested IMF support to sustain macroeconomic and financial stability and safeguard against the detrimental impact of an abrupt deterioration in global financial sentiments following the global financial crisis. Large financial buffers allowed, at least initially, a precautionary type of stand-by arrangement. In light of deteriorating global environment the program was converted from precautionary to borrowing, extended till April 2011 and significantly augmented (from 75 to 560 percent of the quota).

In substance, the second SBA remained focused on fiscal restraint and price stability built on managed currency float to pursue tighter inflation targeting goals set on CPI headline inflation. The overall objective was to quickly and effectively contain the twin deficits and accelerate structural reforms needed to boost domestic supply side and export potential.

The implementation of the second SBA program proved more difficult than expected as multiple downside risks materialized early in the process [28, p. 14], [32].

First, the size and scope of the global financial crises turned out to be more severe than anticipated which, in the absence of adequate financial crisis resolution framework, adversely affected the availability of bank financing; the effect was amplified by the risk-averse behavior of largely foreign-owned banks and the high level of corporate cross-border debt.

Second, the political ownership of fiscal consolidation and critical structural reforms was further weakened by diverse perceptions within the ten-party coalition; especially regarding sustainable levels of pensions and public sector wages, restructuring of state-owned enterprises and public utility companies, and the need for public administration (and public sector) reform (right-sizing).

Third, the adopted growth model based on externally financed aggregate demand stimulus generated unsustainable external imbalances, and failed to produce broader domestic supply response with positive impact on investment, creation of new jobs and growth of competitive exports.

Fourth, the initial conditions burdened by the cumulative effects or prior expansionary policies, severely limited the scope of fiscal policy design, de facto eliminating the possibility for countercyclical fiscal stimulus.

In the presence of these constraints, the fiscal adjustment targets broadly achieved under the second SBA relied mainly on short-term, ad hoc, one-off measures rather than structural improvements based on deeper reforms. Obvious examples were the emphasis on temporary freezing of pensions, public sector wages and new employment instead of deeper reform of the oversized public sector; or linear cuts in discretionary spending instead of seeking improved efficiency of public expenditures through results orientation based on key performance indicators.

At the same time, progress on enterprise restructuring (both SOEs and public utility companies) was disappointing, with an obvious direct negative fiscal impact and a detrimental indirect effect on the perception and ownership of reforms. Combined with very few structural (permanent) improvements of the fiscal balance, the reform program faced serious sustainability issues once the second SBA was concluded in April 2011.

By the end of 2011, the need for fiscal consolidation in Serbia became quite apparent as the debt-to-GDP ratio crossed the 45 percent benchmark (conservatively) set in the Budget System Law. The level was projected to increase to 55 percent at the end of 2012 and reach the Maastricht 60 percent rule by the end of 2013. Although one-off factors and external shocks associated with the global financial crisis worsened the debt situation, the real causes lie in the structural dis-balance between longer-run expenditure commitments (on pensions and public sector wages) and eroding revenue capacity adversely affected by the post-crisis recession and faltering performance of public sector companies [21].

An attempt to provide a timely fiscal consolidation response through a precautionary IMF stand-by arrangement in late September 2011 did not gain enough ownership in the coalition government. The program went off-track at the first review as the proposed 2012 budget failed to observe the agreed targets on new public debt (including government guarantees) and domestically-financed projects. The IMF projected that the true fiscal deficit, including the so called below the line items, would significantly exceed fiscal consolidation targets and jeopardize medium-term fiscal and debt sustainability.

Although this sounded a red alert, the news did not attract much (or any) public attention consumed by the ensuing political cycle centered on the parliamentary and, as it turned out, presidential elections expected in May 2012. Worse, this and other burning macroeconomic and structural issues were further postponed until January 2014 when the backlog of pending EU accession issues were finally resolved.

As already detailed in our previous paper on the subject [40], repeated efforts to resume fiscal consolidation program did not produce appropriate response until the new government survived the flood disaster challenge and finally focused on supplementing its EU accession strategy with a sound fiscal and economic reform program.

In mid-September the Prime Minister Vučić announced government intention to embark on a fiscal consolidation and economic reform program centered on expenditure cuts, better growth-friendly revenue performance, and three pillars of structural reforms: the resolution of state owned enterprises in distress, improved efficiency of public utility/infrastructure companies, and public sector rightsizing. This marked a critical turning point in the political ownership of reforms. The program was discussed with and fully supported by the top IMF management in early October 2014. IMF mission visited Belgrade within weeks. On November 20, 2014 a staff level agreement was reached on the content of the program and detailed measures included in the draft 2015 budget. Due to short preparation time, IMF Board approval of the program, officially labeled a three-year precautionary stand-by arrangement, was scheduled for the second half of February 2015 to allow sufficient time for the implementation of the agreed policy measures and preparation of the initial programs underpinning structural reforms.

More than two years into the implementation of the full fiscal consolidation and economic reform program we have tangible empirical results to evaluate program design and performance, as well as the complex political economy issues that caused the initial 30-month delay in the adoption of the program and presently pose challenges in the continued implementation of critical structural reforms in public utility companies and in rightsizing the overall public sector.

In the next section we will discuss the relevant subset of principles and approaches leading the design of the current three-year fiscal consolidation and structural reform program. Section three will review some of the main results of the program achieved thus far and our realistic economic growth, fiscal and debt expectations for 2017 and beyond. Section four discusses political economy issues and other challenges of fiscal consolidation and structural reforms looming large two months before yet another round of (this time presidential) parliamentary elections expected in mid-April. Last section concludes and draws lessons from Serbia mixed experience with economic reforms and successes of the fiscal consolidation.

The design of fiscal consolidation program

Scope, types and quality of fiscal consolidation programs

Predictably, good fiscal consolidation programs follow some common principles but must be custom tailored to the characteristics and needs of a country. Blanchard's Ten Commandments of Fiscal Consolidation [12] are clearly intended for advanced economies. Most of them are also applicable in transition middle-income economies, but not all. More importantly, transition economies face additional challenges that need to be properly addressed within or in connection with fiscal consolidation program. Case in point are the necessary structural reforms of public sector companies, deep public administration reforms and development of missing market institutions, legal and regulatory framework.

The definition of fiscal consolidation implies an overarching objective of achieving sustainable levels of fiscal deficit and public debt (as discussed in our paper [40] or "achieving (or maintaining) external viability" in the context of IMF institutional mandate. Over the years we observed a great variation in actual program objectives which can be grouped in three different types of programs [28]:

- Classic stabilization and adjustment programs aimed primarily at correcting the current account and fiscal imbalance (twin deficits) and restoring the foreign exchange reserves at safe levels;
- Capital account crisis programs aimed at restoring the confidence of international capital markets and preventing capital flight (i.e. sudden loss of private external financing); and
- Reform programs with a primary aim of achieving sustainable levels of fiscal deficit and public debt in support of structural reforms for economic growth and stability.

In each case the quality of the program was of paramount importance. Recent reviews of the IMF supported programs indicate that realism of program objectives and the composition of the policy interventions are critical for good performance and achievement of meaningful and sustainable results. In light of frequent implementation underperformance reported in IMF supported programs, it should be noted that calls for less ambitious goal setting may be justified only if it secures the achievement of higher order objective (i.e. sustainability, higher order growth path). The experience also indicates that tendency to set overoptimistic goals increases with time: empirical tests do not find a significant bias in short-run GDP growth projections, but over-prediction of growth dynamics increases as the time horizon extends beyond one year, irrespective of the program type [28] and [32].

Sources of divergence between projections and outcomes include:

- incomplete/insufficient information at the program design stage;
- imperfections of the (modeling/analytic) framework;
- gaps in institutional expectations of the governments and the IMF Executive Board;
- inaccuracies and errors in the preliminary statistical information used for program design and monitoring;
- bias in BoP projections driven by the available resources;
- theoretical/analytical inconsistencies between different modules and toolkits (financial programming, balance-sheet approach, vulnerability assessments, debt-sustainability analyses) in the absence of a model-based mutually consistent theoretical framework.

It is particularly noteworthy identifying the difficulty in adapting the financial programming framework to design reform programs since it takes growth and foreign financing as purely exogenous (rather than endogenous part connected to structural reforms or part of an empirical cross-country growth framework of reference).

Finally, a survey of past experiences indicates that the comparisons of program objectives and performance targets with actual outcomes confirms that more ambitious fiscal contractions are associated with better growth performance, while more ambitious monetary contractions are associated with worse outcomes. This holds both in the short and the longer run and the type of fiscal adjustment matters: current expenditure cuts are more conducive to growth, especially if capital expenditures (investment) are protected [28, Ch 5].

On the implementation side, the findings suggest that stronger political and institutional environment and stronger ownership of the program are conducive to better program implementation which in turn produces superior macroeconomic outcomes [28, Ch 15].

On the opposite side, program design and implementation is weakened by strong special interests in the parliament, lack of political cohesion, political instability, ethno-linguistic divisions and inefficient bureaucracies [28, Ch 10].

The design and content of Serbia fiscal consolidation program

Compared to a sequence of IMF supported programs after year 2000 described in the introduction, this reform program offers a more comprehensive coverage, medium-term three-year timeframe, stronger ownership/commitment to structural reforms, design realism, better implementation readiness and track record.

Formally, the present IMF-supported program represents a three-year precautionary stand-by arrangement backed by a resource envelope equal to 150 percent of the quota. From the content side, Serbia fiscal consolidation program is embedded in a wider set of economic reforms with comprehensive coverage of three essential dimensions of a functioning market economy able to restore its growth potential and compete in the EU and global markets:

1. Macro-monetary and macro-fiscal/public debt block with an objective of sustaining macro-price and exchange rate stability, reducing budget/fiscal deficits and public debt to sustainable levels;
2. Financial sector block with an objective of providing adequate business and consumer financing at competitive interest rates by cleaning the books of banks through asset quality review and comprehensive NPL resolution scheme; and
3. Growth enabling micro/structural block with an objective of improving legal and institutional aspects of business environment/investment climate, and advancing the three pillars of structural reforms: (a) resolving the status of companies in the portfolio of Privatization agency through privatization or bankruptcy; (b) improving the performance of public utility/infrastructure companies; and (c) reforming, modernizing and rightsizing the public sector including public administration and local government, military, police, health, education, social and other public services.

In each of the areas, some vital program elements rest on existing policy design and implementation mechanisms that continue to be used with little or no change. Best examples are monetary policy based on inflation targeting and managed foreign exchange float, the annual budget and the three-year fiscal strategy preparation process.

In other cases, policy design and implementation mechanism have been adapted, improved or changed to meet the program requirements. One such example are enhancements in the macro-fiscal policy block to secure expenditure cuts, and increased tax and non-tax revenues with neutral or positive impact on economic growth. More specifically: (a) the design and implementation of expenditures the necessary spending cuts, especially in the areas of large mandatory spending commitments on pensions and public sector wages, (b) better and more efficient tax administration, especially of VAT and excise taxes, to secure wider tax base and higher tax revenues based on existing tax rates, (c) smooth introduction of well targeted new tax instruments (such as electricity excise tax), fees, and charges that would secure structural improvements in revenues and maintain a clear pro-growth orientation of the program.

Finally, new policy design and implementation mechanism have been and will continue to be created to: (a) better target social protection and social assistance programs; (b) enable and facilitate structural reforms through transparent, just, well designed, and properly funded voluntary separation, redundancy, rightsizing, early retirement and similar programs; (c) improve the design of subsidies in agriculture to meet the EU standards and achieve rural development objectives; and (d) develop more robust subsidies and incentive schemes to support direct investment, job creation, production, export growth and regional development.

In short, fiscal consolidation is both the lead and the centerpiece of the broader comprehensive economic reform program [7] and [8]. Improved fiscal performance early in the program can only be sustained over time if structural reforms are properly planned, developed and funded. To do this, Serbia fiscal consolidation and economic reform program counts on close collaboration with and support from the World Bank, EBRD, EIB and other IFI's, bilateral donors as well as EU. Key examples are:

- the resolution of SOEs supported through two World Bank DPLs;
- restructuring and improved performance of public utility/infrastructure companies supported by one or more World Bank DPLs and EBRD loans;
- improved competitiveness through innovations, better labor market operations and improve policy analysis supported by World Bank results based funding loan;
- public administration reform supported by World Bank program-for-results loan and EU sector budget support financing; and
- numerous sector and thematic studies funded by bilateral donors and IFIs.

Results of the program: The first two years

Fiscal balance developments

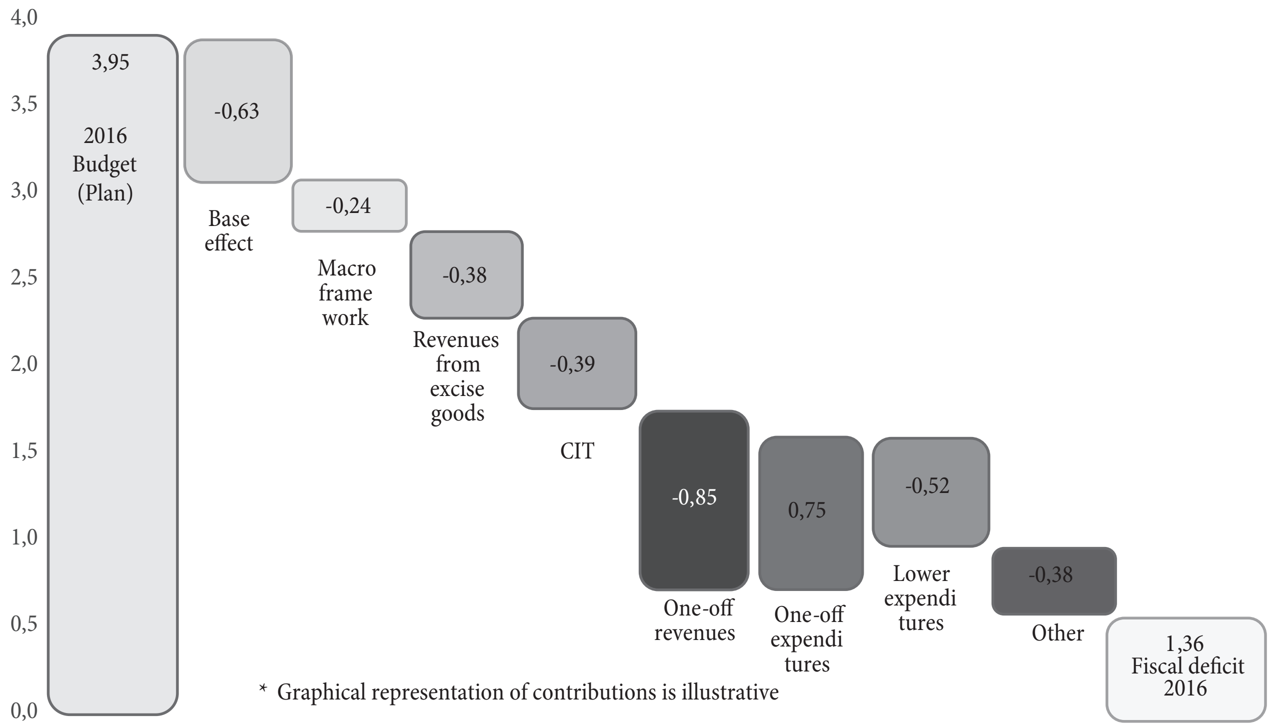
During the first two years of the program fiscal performance substantially exceeded the original and the revised deficit targets set in the IMF supported three-year precautionary program. In 2015, planned general government deficit was set at 232 billion dinars or 5.9 percent of GDP. Based on very good performance during the first six months, target deficit was revised down to 160 billion (4.0 percent of GDP), while the actual outcome for the year was still below (149.1 billion or 3.7 percent of GDP). This is 2.2 percentage points better than the planned deficit and 2.9 percentage points below the deficit recorded in 2014, indicating a huge improvement both on the revenue and expenditure side.

The over-performance in 2016 was even bigger: the nominal general government fiscal deficit was planned at 3.95 percent of GDP and the actual deficit turned out to be 1.36 percent of GDP, including the assumption of old debts, seasonal cost overruns and one-off elements. As detailed in Figure 1 below, the 2.6 percentage point better performance is owed to faster growth, improved tax revenues from excise goods and higher corporate profits, lower expenditures, and, on balance, somewhat larger one-off revenues than expenditures.

More importantly, permanent structural improvements in the fiscal balance stand at 4.4 percent after two years of the program. This exceeds the overall 4.0 percent total fiscal adjustment target one year ahead of the IMF program. Compared to the initial plan (50:25:25), this implies considerably stronger front loading (57.5:45:0) and allows more fiscal space for the implementation of difficult structural reforms in the last year of the program. In practice, the speed of fiscal consolidation [11] and policy credibility [12] were of lesser importance.

For the second year in a row the fiscal adjustment was spread evenly throughout the year as indicated in Figure 1 below. The improvements have been recorded in every single month. The December spike in expenditures and deficit remained albeit at a somewhat lower level (RSD 50.1 billion in 2016 versus RSD 83.7 billion in 2015, and RSD 88.4 billion in 2014). The December seasonality was caused by three main factors: (1) weaknesses of budget planning and execution which, predictably, lead to bunching of payments late in the year to compensate for prior delays in both capital and current non-wage costs;

Figure 1: Serbia - contributions to improved fiscal deficit in 2016, in % GDP



Source: Ministry of Finance.

Table 1: Serbia – improvement in fiscal deficit explained, in % of GDP

	2015	2016	Total
TOTAL ADJUSTMENT IN THE FISCAL BALANCE	**2.9**	**2.2**	**5.1**
Of which: permanent structural fiscal balance change	2.60	1.80	4.40
Total adjustment on the revenue side	**1.90**	**3.50**	**5.40**
Of which: permanent structural revenue changes			
Better revenue performance (VAT, excises, contributions)*)	1.0	2.5	3.5
Of which: revenue changes with one-off effects			
Extra dividends and profits of public companies	0.8	0.2	1.0
Increases in other non-tax revenues**)	0.1	0.8	0.9
Total adjustment on the expenditure side*)**	**1.0**	**-1.3**	**-0.3**
Of which: permanent structural expenditure changes			
Pension reductions	0.6	0.0	0.6
Public sector wages reductions	1.0	0.0	1.0
Other expenditures permanent effect on fiscal balance****)	0.0	-0.7	-0.7
Of which: expenditure changes with one-off effects			
Interest payments	-0.4	0.0	-0.4
*Subsidies*****)*	0.4	0.0	0.4
Capital expenditures	-0.4	-0.6	-1.00
Increase in expenditures	0.0	-0.7	-0.70
Assumed debts******)	-0.1	0.7	0.60

*) In 2016 includes 0.4% CIT, 0.7% VAT, 0.5% contributions, 0.2% excise taxes and 0.2% Telecom dividends.
**) Includes 0.3% effect of the change in methodology.
***) Positive number indicates reduction in expenditures i.e. positive fiscal impact.
****) Includes 0.3% goods and services, 0.1% social transfers, and 0.3% other expenditures.
*****) Includes reductions/changes in all subsidies.
******) Includes assumption of public company debts, recapitalization of banks and insurance companies, military pensions, ad ag-subsidies.

(2) precautionary pressures to advance transfers for wages and pensions from early January to December; and, most importantly, (3) opportunistic but justified behavior to assume portions of pending debts and thus utilize the space earned through better fiscal performance during the year.

As shown in the Figure 2, the first two factors (relocation of current and capital expenditures) amounted to RSD 7.3 billion in 2014, RSD 18 billion in 2015 and RSD 29.1 billion in 2016. The assumption of debts amounted to RSD 40.9 billion in 2014, RSD 43 billion in 2015 and RSD 13 billion in 2016. Although no payments are made in the current year, the amounts are recorded both as increased public debt and cash-based fiscal deficit. This departure from the cash-based fiscal accounting rules was requested in 2012 by the IMF to curb the scope for further public debt increases through the assumption of public company and bank debts. Despite possible methodological objections, this hybrid accrual-cash rule proved useful over the years and presently leads to opportunistic assumption of debts when the necessary fiscal space has been created.

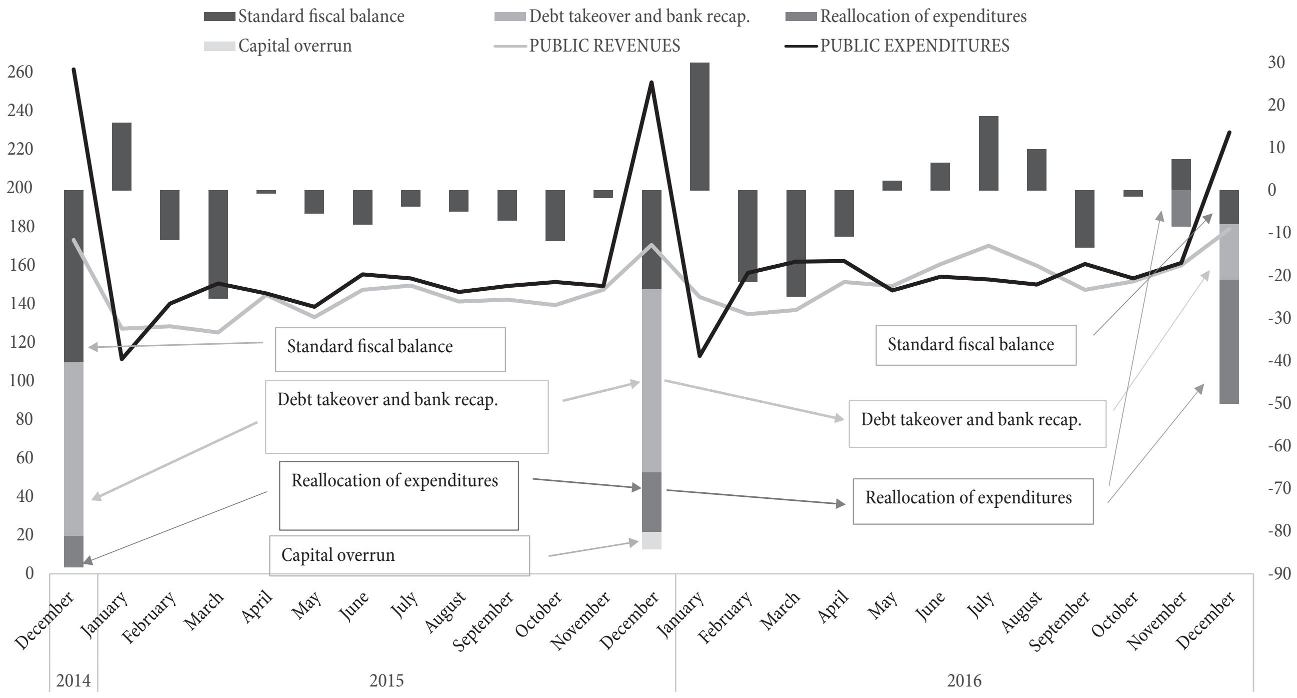
In short, fiscal consolidation was built both on broad-based expenditure cuts and better revenue performance. Out of 2.9 percent fiscal balance improvement over 2014, predominant part (2.6 percentage points or 89 percent of change) stems from permanent, structural improvements. In that, permanent expenditure cuts contribute 3/5 (1.6 percentage point) and structural revenue improvements 2/5 (1.0 percentage point).

Economic growth: Was there a recessionary impact of the program?

One of the major concerns of governments embarking on fiscal a consolidation program based on expenditure-cut was the potential recessionary impact [5] and [6]. These concerns were exacerbated in the presence of global recessionary pressures [15], external shocks [10] and multiple constraints to growth [18].

In Serbia, additional concerns regarding growth impact of a possible fiscal consolidation program came

Figure 2: Serbia - December seasonality explained, monthly fiscal balance 2014-2016



Source: Ministry of Finance.

from the fact that brief economic expansion in 2013 came from the introduction of FIAT production and exports. Although car production and exports continued, additional effects on economic growth were negligible and recessionary pressures resumed in the first quarter of 2014. The prevailing perception was that fragile growth could not withstand an additional shock from fiscal consolidation [12] and [14].

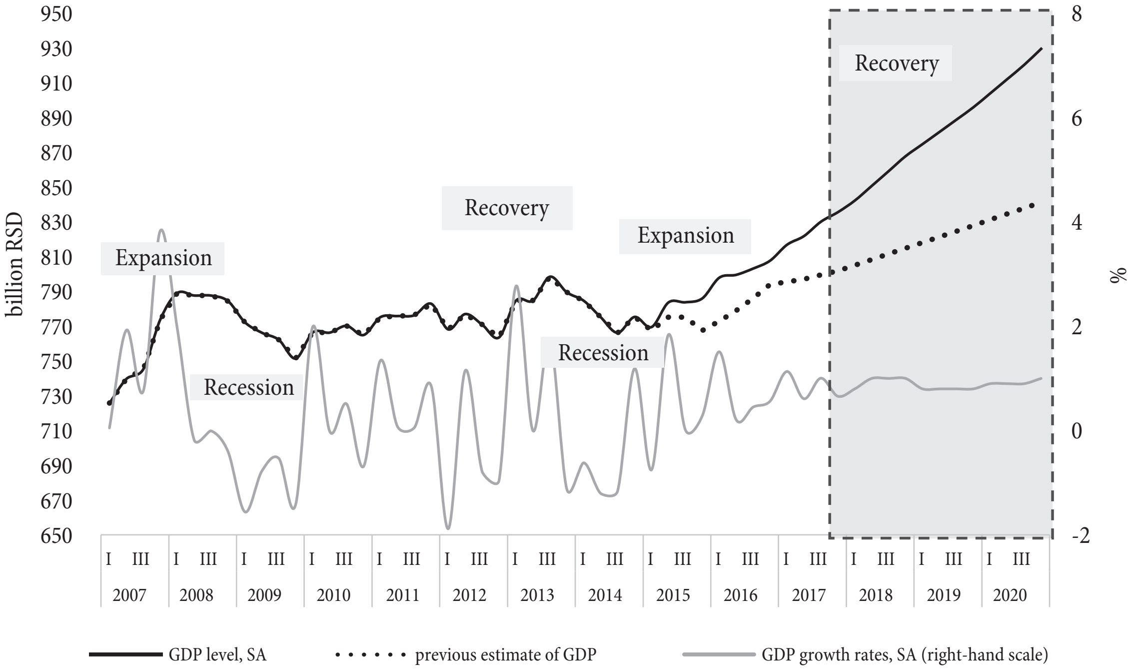
The negative impact of May 2014 floods on GDP growth demonstrated how fragile the un-restructured economy was and actually reversed the sentiments in favor of tough reforms that would ultimately create a more robust economy. It became apparent that the call for fiscal consolidation and economic reforms was not just an electoral pitch for more votes, but a sign of ownership and clear commitment to follow a difficult path out of decades long economic decay [4].

The turning point came in the third quarter and the economy started recovering in late 2014-early 2015. Despite conservative projections from the IMF and other IFIs that growth will remain negative throughout 2015 (between -0.5 and -1.0 percent), the economy dipped out of recession and reached a positive 0.8 percent growth for the entire year.

It appears likely that the strong growth recovery established in 2016 will continue throughout the 2017-2019 period covered by the latest Fiscal Strategy yielding a substantial difference in GDP and all related economic and welfare indicators. The difference is depicted by the area between the GDP levels predicted without the reform (dotted line) and with the reform (full line).

The case of Serbia may be getting close to what has been labeled as an “expansionary austerity” paradox. As explained by Alesina [1] and empirically demonstrated in Alesina et al. [4], Auerbach [5], [6] and Pescatori et al. [36], when fiscal consolidation programs are designed in line with sound principles summarized by Blanchard and Leigh [11] and [12] and synchronized with key structural reforms and pro-growth policies [20] and [33]. Carefully selected expenditure cuts combined with revenue collection efforts aimed at shadow economy described in Table 1 above show that initial fiscal adjustment does not have to be recessionary even under most difficult circumstances, despite ongoing debate [20], [24], [27] and persistent criticism [35], [12], [16], [19] and [39]. An upward 1.3 percent growth rate revision captures not only the “conservative buffer error” but also indicates

Figure 3: Serbia GDP level and growth rates, quarterly data



Source: Statistical Office of Serbia, Ministry of Finance Staff Calculations.

that there are positive behavioral changes and responses to persistent and comprehensive reform effort.

Public debt and program consistency

Stopping the growth of fiscal deficit and the buildup of public debt are the main reasons for embarking on a fiscal consolidation program. Achieving the sustainable levels of fiscal deficit and public debt are the desired outcomes of a well-designed fiscal consolidation program [26]. Figure 4 summarizes the developments in these variables since 2008. Fiscal deficit levels followed an expansionary trend from 2008 until the introduction of the fiscal consolidation program. The level of public debt (expressed as current debt-to-GDP ratio) followed the same pattern. The reduction in fiscal deficits already achieved in 2015 (3.7 percent) and 2016 (1.36 percent) could be the basis for a more ambitious planning targets in 2017 (1.7 percent) and convergence to sustainable fiscal deficits in 2018 and beyond.

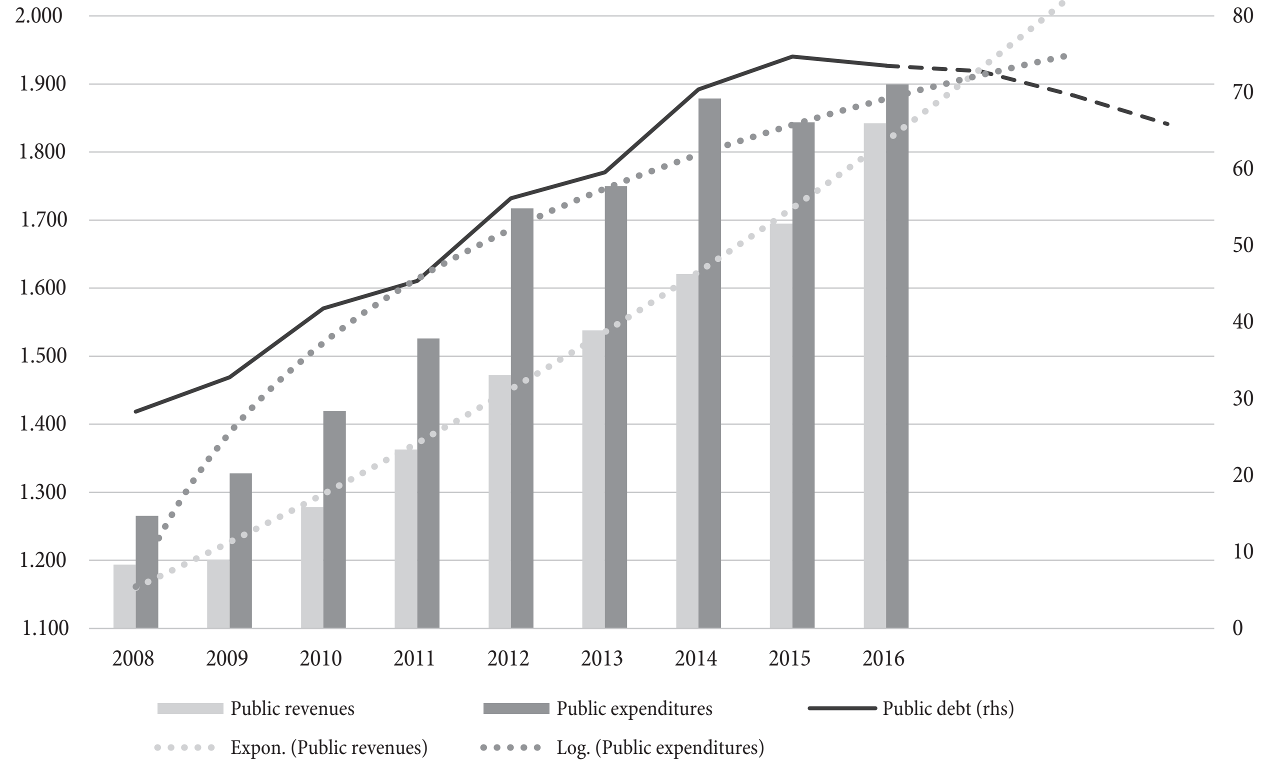
Fiscal surpluses implied by the intersection of fitted lines in Figure 4 below do not represent projections or requirement to secure a turning point in the debt-to-GDP ratio. With the prevalence of primary fiscal surpluses starting with 2016 (1.8 percent actual) and 2017 (1.4 percent projected), in tandem with declining cost of international borrowing and stable projected GDP growth rates (3 percent in 2017 and 3.5 percent in 2018-2019), the share of debt in GDP will be put on steady declining trend. Further reductions in borrowing costs are quite likely in line with continuously improving credit rating which will add to this tendency [13].

As indicated in Figure 5, increased country risk and large borrowing needs quickly increased the cost of public debt from 0.4-0.6 percent of GDP in pre-crisis years to 1.0-3.2 percent in the subsequent period. This tendency could not be changed quickly due to built-in lags. Starting with 2016 Serbia is reaping the first benefits of fiscal consolidation (and improved credit rating) through lower cost of borrowing. This will gradually narrow the difference between overall and primary fiscal balance and, together with stable GDP growth rates, help achieve long-run debt sustainability.

Program implementation issues

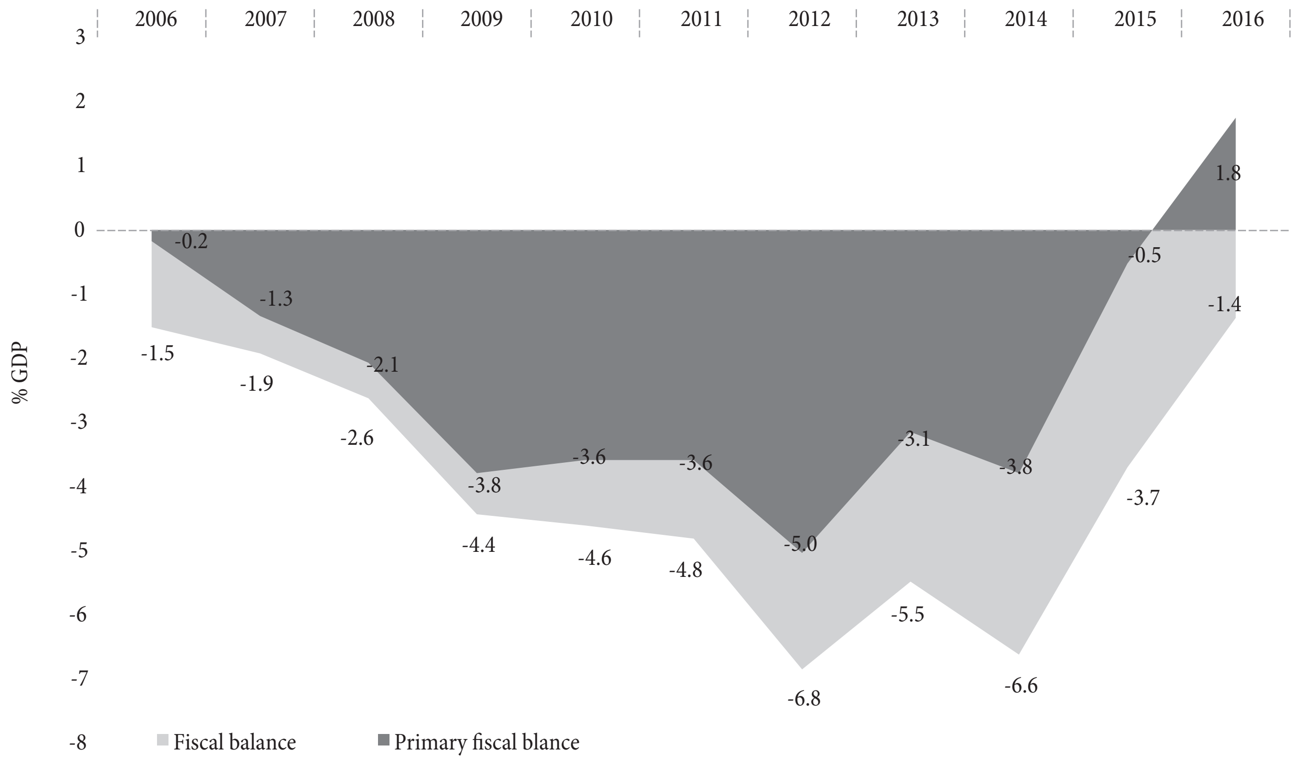
Based on previous track record of IMF-supported programs in Serbia and experience in comparator countries with similar reform programs, there was a notable tendency to include sizeable buffers in key aspects of the program. This became particularly obvious during the implementation

Figure 4: Serbia - public revenues, public expenditures, and debt-to-GDP ratios



Source: Ministry of Finance, Public Debt Department.

Figure 5: Serbia - primary and overall fiscal deficit: Sustainability issues



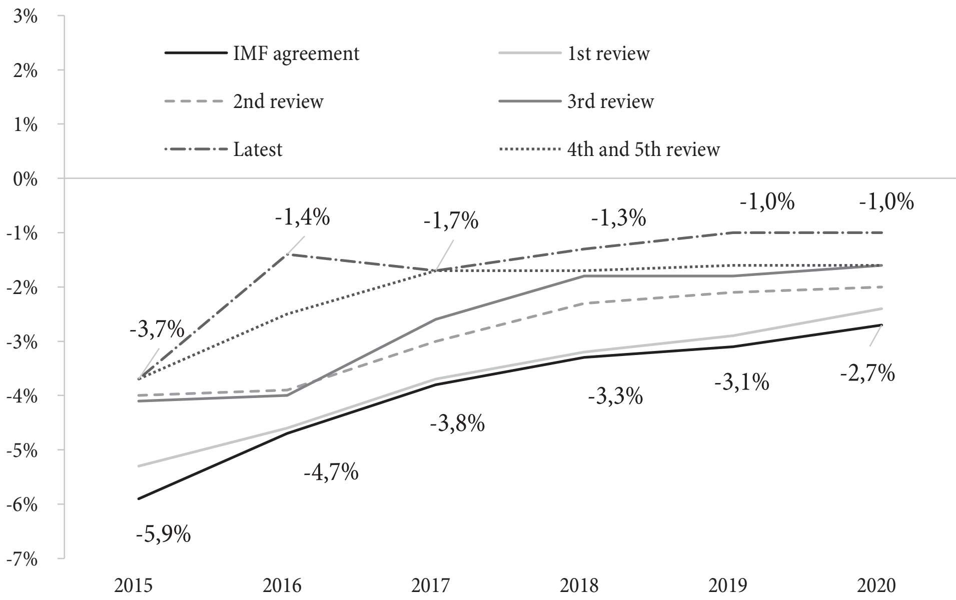
Source: Ministry of Finance.

of the ongoing program. As clearly visible in the figures below, there was a tendency to underestimate the size and scope of fiscal adjustment resulting in higher projected fiscal deficits. The gap was wider in the short run (between 2.2 and 3.3 percentage points for the following year, i.e. 2015 and 2016) and gradually narrowed in the longer-run (1.7 to 2.0 percent in 2019-2020).

Similar tendency is observed regarding the projected level of primary balances. The gap between initial program figures (produced in October 2014) and the latest revisions (done in late 2016) was as wide as 3.3 percentage points for 2016 and it substantially narrowed to only 0.4 percentage points for the medium run (2020).

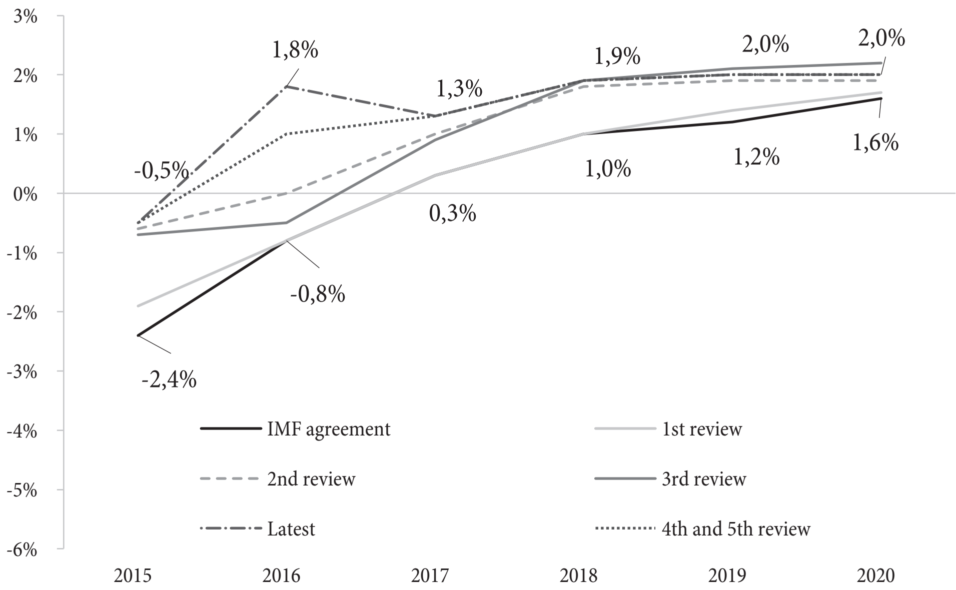
It is worth noting that almost all revisions represented improvements (lower fiscal and primary deficits, lower public debt and higher GDP growth rates), indicating a visible downward bias grounded in the history of consistently overly optimistic projections (especially

Figure 6: Serbia – general government fiscal balance, % of GDP



Source: IMF and Ministry of Finance.

Figure 7: Serbia – general government primary balance, % of GDP



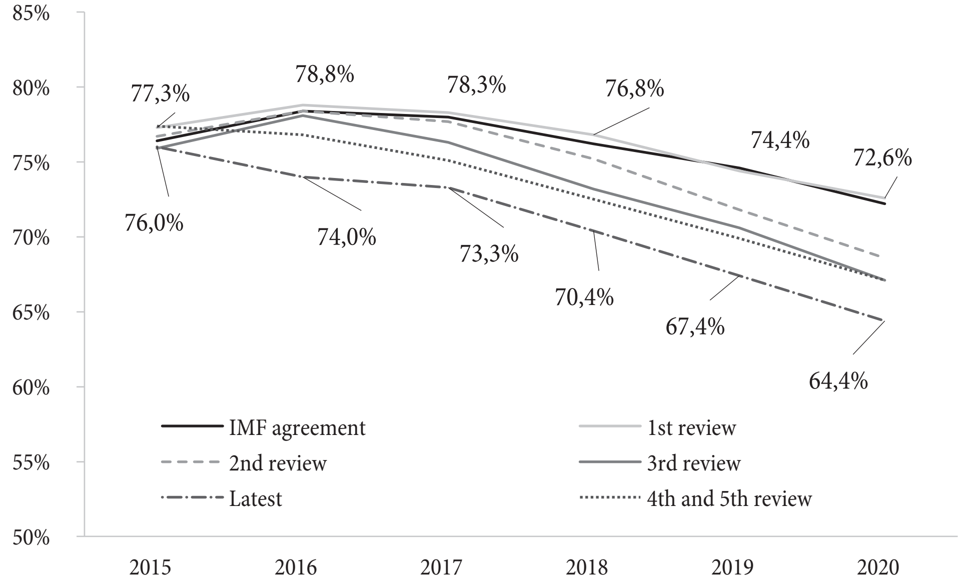
Source: IMF and Ministry of Finance.

regarding revenues and nominal GDP) and implementation underperformance (both on the fiscal front and in structural reforms). Whereas, despite visible improvements under this program, some reservations may be justified regarding the ownership and pace of structural reforms, we do not see sufficient justification for addressing possible downside risks through systematic downward bias in projected deficit, debt and GDP growth figures. Positive track record should be allowed to improve the accuracy of macroeconomic projections and devise separate risk mitigation measures if and when needed.

Remaining challenges faced by the program

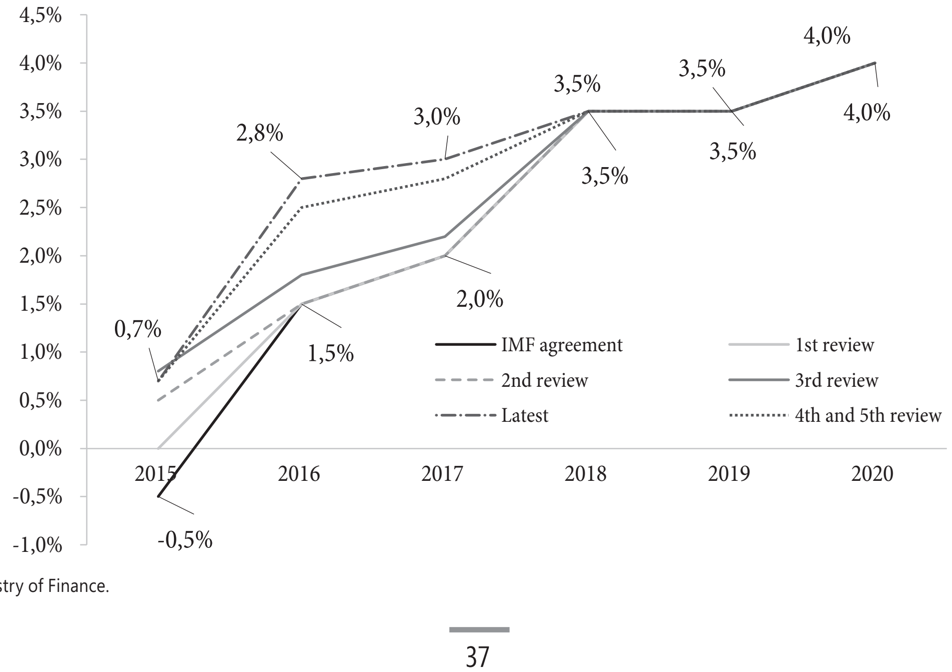
As previously discussed [40], the political economy issues grow in importance before the presidential elections expected in mid-April 2016. Last Parliamentary elections confirmed the broad reform orientation of the ruling majority coalition. But it also reopened some of the politically sensitive issues regarding the social cost of reforms stemming from the perceived (more than real) reform effects on pensions, public sector wages, and public sector jobs. The fact that the incumbent Prime Minister

Figure 8: Serbia – central government debt, % of GDP



Source: IMF and Ministry of Finance.

Figure 9: Serbia – GDP growth rates, % per annum



Source: IMF and Ministry of Finance.

won the elections and secured, with the usual coalition partners, a large majority in Parliament speaks clearly in favor of reforms and results achieved thus far. It also gave additional visibility and importance to promised pension and select public sector wage increases within the established structural (permanent) fiscal deficit improvements achieved in 2015-2016.

It looks like that the forthcoming Presidential elections will provide another opportunity to secure political and social support for continued efforts needed to resolve problematic SOEs and public utility companies. But this will not be simple in the midst of complex electoral politics and in face of growing reform fatigue among swing political factions and vulnerable groups.

As already discussed [40], fiscal consolidation has been postponed a few times and the 2011 SBA program ultimately rejected based on requests / expectations of special interest groups with significant political influence. Although the discussion of special interest groups in Serbia, their behavioral patterns, political alliances, and related political economy considerations goes beyond the scope of this paper, we will reiterate two examples that clearly indicate deep fiscal consequences of unresolved political economy issues in Serbia.

The first is the political strengthening of pensioners during the transition process. In close alliance with the Socialist Party of Serbia, they have openly resisted some of the key market reforms including efficient and full privatizations, protection of property rights, the development of efficient market institutions, to mention just a few. More importantly, they used their special political position critical for forming majority coalitions, to effectively change the share of pension expenditures vis-à-vis public sector wages and as share of GDP. As clearly shown in Figure 4 above, the share of pensions in public revenues jumped from 27.7 in 2008 to 32.3 percent in 2009. This increased the combined share of pensions and public sector wages to 62.0 percent and generated unsustainable expenditure commitments which significantly contributed to increased deficits and public sector debt.

The second was an apparent need of the government to raise more financing than needed to cover the fiscal deficits. This happened in six out of nine years prior to 2014 (see Figure 5 – years in which net financing-black full line, exceeds fiscal deficit – light line). Again, political economy reasons were critical in understanding these developments but fiscal consequences on growing debt service charges, especially interest payments as Serbia faced quite unfavorable lending terms during that period,

Present political economy issues can slow-down structural reforms

At this stage, fiscal consolidation measures have already taken solid ground. The effects of measures on fiscal deficit, economic growth, and longer-term public debt dynamic have been established and, although important implementation risks remain, Serbia is moving towards achieving or exceeding the fiscal targets set for the three year IMF supported program.

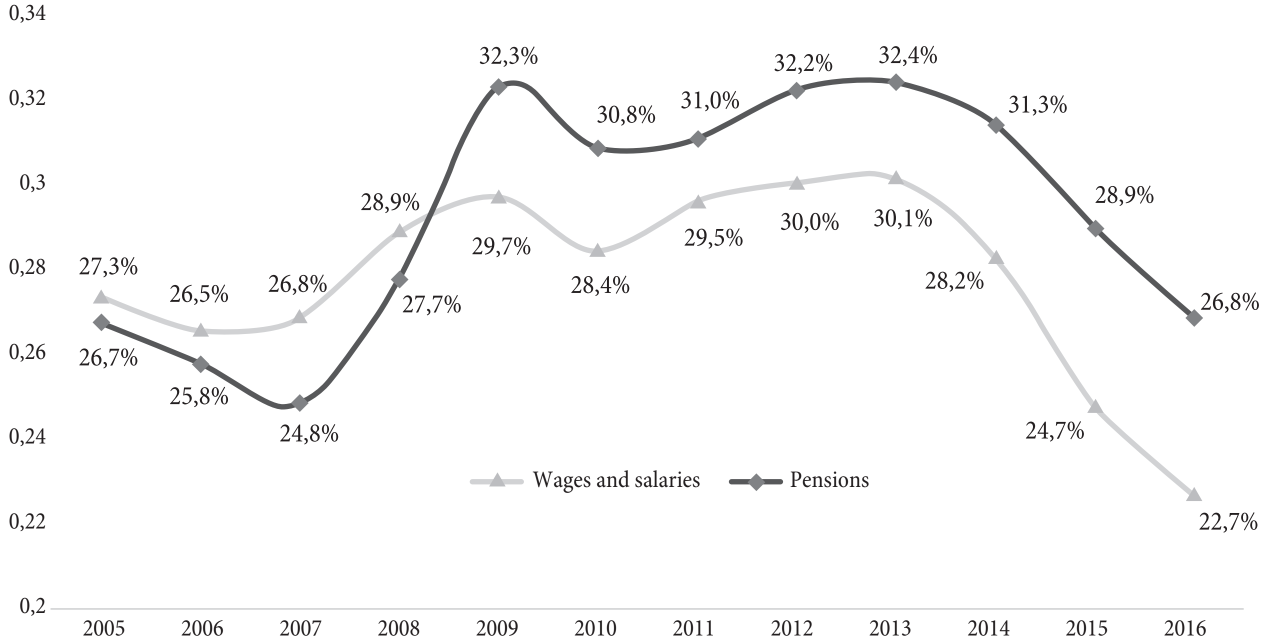
The key implementation risks are now on advancing structural reforms in resolving the status of enterprises in the Privatization agency portfolio, improving management and performance of public sector utility/infrastructure companies, reforming and rightsizing the public sector, and resolving NPLs in the banking sector. And each faces considerable push-back and obstruction from both workers and old management in general, labor unions which appear to be considerably stronger and protective of their privileges in public companies with large number of employees and, often, excessive overemployment. Resistance increases exponentially as the deadlines for inevitable reforms, rightsizing and restructuring plans come closer. The process is surprisingly misguided and stuck in positional bargaining "armed" with threats to strike or worse. Principled negotiations are practically non-existent. Deeper political divides behind the scenes make the whole process even more difficult. Pre-election sensitivities make this impasse almost impossible to handle rationally and effectively.

Most importantly, the complex political economy issues based on one-sided perception of status-quo interests could be misused by opposing political blocks to elevate the stakes in ensuing political campaign at the longer-term expense of the country. The country badly needs fresh thinking about dynamic trade-offs where everybody wins in the medium run if reforms are completed, and most everybody loses if reforms are stalled or abandoned. This should be the back-bone of pro-reform and pro-EU campaign in Serbia. One can only hope that Serbian polity will see or feel that other political, economic and social alternatives offered at this time are inferior.

Conclusion

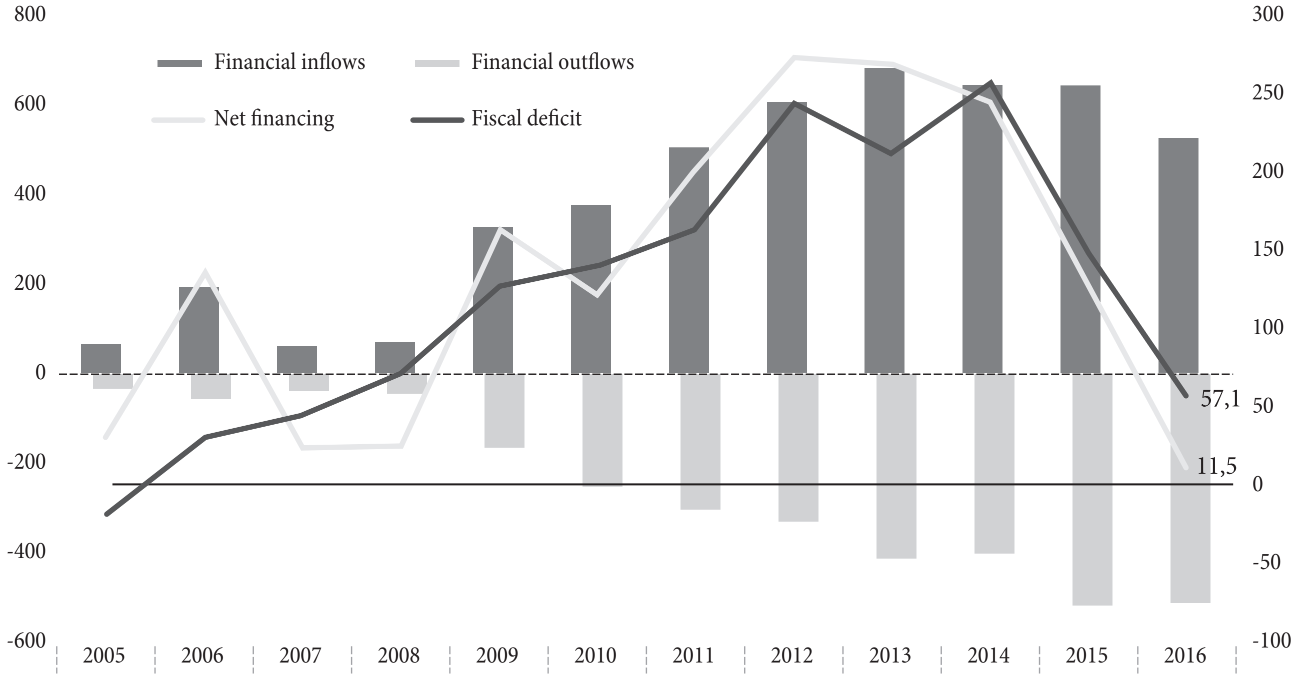
Fiscal consolidation in Serbia was based on a comprehensive, multi-year program built on broad-based expenditure cuts, better revenue performance, and related structural reforms and pro-growth policies. During the first two year of implementation the actual fiscal performance substantially

Figure 10: Serbia - share of public sector wages and pensions in revenues



Source: Ministry of Finance.

Figure 11: Serbia - financial flows, net financing, and fiscal deficit, in RSD billions



Source: Ministry of Finance.

exceeded the original and revised deficit targets set in the IMF supported three-year precautionary program. In 2015, the actual deficit of 3.7 percent of GDP represented a huge 2.9 percentage point improvement over the 6.6 percent deficit recorded in 2014, and a 2.2 percentage point over-performance vis-à-vis the program target. In 2016 the implementation performance further improved. The actual deficit of 1.36 percent of GDP was 2.6 percentage points better than the plan. The improved performance was achieved despite a sizeable assumption of old public company debts, and the absorption of seasonal spikes in expenditures.

This nominal result contains an even more impressive structural deficit improvement of 4.4 percentage points which exceeds the overall 4.0 percent total structural fiscal adjustment one year ahead of program schedule. The improvement was composed of 0.9 percentage points in permanent expenditure cuts and 3.5 percentage points in structural revenue improvements. This result is owed to substantial (2.6 percentage points) frontloading of public wage (1.0) and pension (0.6) adjustments on the expenditure side and better revenue performance (1.0). The second year structural improvement (1.8 percentage points) was owed to significantly stronger revenue performance (2.5) and reversal of structural savings on the expenditure side (-0.7) due to pension and wage adjustments.

The program had a beneficial impact on economic growth. The economy bottomed-out in the third quarter and started recovering in late 2014-early 2015 leading to a positive 0.8 percent growth for the entire year. The growth further recovered in 2016 (+2.8 percent) and is expected to reach 3 percent in 2017 and stabilize at 3.5 percent annually thereafter.

With this combined growth and fiscal performance Serbia may become a case of "expansionary austerity". As explained by Alesina [1] and Alesina et. al. [4], fiscal consolidation programs designed in line with sound principles summarized by Blanchard and Leigh [11] and [12] and synchronized with key structural reforms and pro-growth policies can generate growth. Carefully selected expenditure cuts combined with pro-growth revenue collection efforts can have expansionary effect on growth even under most difficult circumstances. An upward 1.3 percent growth rate revision captures the "conservative buffer error" and indicates that there are positive behavioral changes and responses to persistent and comprehensive reform effort.

The political economy issues of fiscal consolidation and structural reforms are increasing in importance ahead of Presidential elections. The key implementation risks will turn to securing progress of structural reforms in SOEs and public utility/infrastructure companies, reforming and rightsizing the public sector, and resolving remaining NPLs in the banking sector. And each faces considerable push-back and obstruction from labor unions, managers and other vested interest groups. Resistance increases exponentially as the deadlines for inevitable reforms, rightsizing and restructuring plans approach.

The resolution process is surprisingly misguided and stuck in positional bargaining. Deeper political divides threaten to further complicate the process. Fresh thinking is needed to demonstrate dynamic trade-offs where everybody wins in the medium run if reforms are completed, and most everybody loses if reforms are stalled or abandoned. This should be the back-bone of pro-reform and pro-EU campaign in Serbia. One can only hope that Serbian polity will see or feel that other political, economic and social alternatives are inferior.

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