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ECONOMIC RECOVERY, EMPLOYMENT AND FISCAL CONSOLIDATION: LESSONS FROM 2015 AND PROSPECTS FOR 2016 AND 2017

Privredni oporavak, zaposlenost i fiskalna konsolidacija - pouke iz 2015. i izgledi za 2016. i 2017. godinu

Abstract

Slow economic growth, excessive fiscal deficit accompanied with rising public debt as well as high unemployment, represent the main problems Serbian economy is facing. The economic recovery has started in 2015 after the 2014 recession. However, economic growth will still remain sluggish in the following years as resolving structural problems and investment increase (relative to GDP) will take some time to achieve. Lowering the fiscal deficit to 3.7% GDP in 2015 from 6.6% GDP in 2014 represents a good result. Nevertheless, further (and necessary) decrease of the deficit will present a challenge as appropriate measures were not adequately planed, while at the same time the needed reforms were not implemented. Additionally, there is a risk of incurring new fiscal costs as a result of a weak performance of public and state owned enterprises. The ongoing economic recovery demonstrates a negligible adverse impact of fiscal consolidation on economic growth. In the long run, fiscal consolidation has a positive effect on growth as it ensures macroeconomic stability needed for investment increase. Strong employment growth in the previous three years amid economic stagnation has not actually happened, and is a consequence of unreliable evaluation of labor market trends done by SORS. The Government is tasked with considerable challenges in 2016: to resist premature fiscal relaxation and concentrate efforts to improve the investment climate, as it leads to stronger growth and consequently rising employment.

Keywords: *economic recovery, investments, fiscal multiplier, employment, fiscal consolidation, fiscal deficit, public debt*

Sažetak

Nedovoljan privredni rast, preveliki fiskalni deficit uz brzo rastući javni dug i visoka nezaposlenost su najveći problemi ekonomije Srbije. Nakon recesije iz 2014, privredni oporavak je započeo u 2015. godini. Međutim, rast privrede još nekoliko godina će biti nizak, jer je potrebno nekoliko godina da se otklone postojeći strukturni problemi i poraste učešće investicija u BDP. Fiskalni deficit smanjen je u 2015. na 3,7% BDP sa 6,6% BDP iz 2014. godine, što je odličan rezultat. Ali dalje (neophodno) smanjivanje deficita će ići teško, jer nisu pripremljene dovoljno dobre mere, niti sprovedene sve potrebne reforme – a uz sve to postoji rizik novih fiskalnih troškova usled neuspešnog poslovanja javnih i državnih preduzeća. Započeti privredni oporavak u 2015. pokazuje da je negativan uticaj fiskalne konsolidacije na privredni rast u kratkom roku veoma mali. U dužem roku fiskalna konsolidacija povoljno utiče na privredni rast jer obezbeđuje makroekonomsku stabilnost, koja je jedan od preduslova za potrebni rast investicija. Snažan rast zaposlenosti u prethodne tri godine uz stagnaciju privredne aktivnost se, po svemu sudeći, nije ni desio već je posledica nepouzdanosti praćenja kretanje na tržištu rada od strane RZS. Vlada u 2016. i narednim godinama ima veliku odgovornost – u fiskalnom domenu, da ne dozvoli preuranjeno popuštanje restriktivnosti, a da za povećanje privrednog rasta i, posledično, zaposlenosti, uloži veće napore na unapređenju investicionog ambijenta.

Ključne reči: *ekonomski oporavak, investicije, fiskalni multiplikator, zaposlenost, fiskalna konsolidacija, fiskalni deficit, javni dug*

Introduction

Three largest structural problems of Serbian economy are: insufficient economic growth, excessive fiscal deficit with a fast-growing public debt and high unemployment. Last year, in 2015, certain improvements in these indicators have been observed. Economic activity has started recovering after the recession from 2014 and, according to the fist estimates, the GDP growth in 2015 amounted to 0.6%. The fiscal deficit was decreased to 3.7% of GDP from 6.6% of GDP in 2014. At the same time, unemployment decreased from quarter to quarter, according to the data from the Labour Force Survey (LFS), so that in the third quarter of 2015 (last available data) it was 17.3%, which is a 1.5 pp decrease in comparison to the same period last year. However, the observed improvements are insufficient (with regards to the unemployment decrease, there are doubts as to whether it actually even occurred) and they are still not firmly rooted. This is why there is a risk that the positive trends may grind to a halt after 2015 – i.e. that the fiscal deficit in the medium term may remain higher than 3.5% of GDP, economic growth may stay under 2% and unemployment may stagnate or increase. This is why the Government has such a great responsibility in 2016 – in the fiscal domain, it should not allow premature relaxation of the restrictions and give up on the unpopular and harsh measures; and in terms of economic growth and consequently, increase in employment, it should invests greater efforts in improving the business environment.

Serbian economic growth of 0.6% in 2015, as well as the expected growth of 1.8% in 2016, is slower in comparison to all other comparable countries of Central and Eastern Europe. Low economic growth is actually a somewhat lasting trait of economic trends in Serbia, being that ever since the first wave of the crisis ended (2010) until 2015, the average economic growth rate was only 0.3%. To establish a strong, sustainable economic growth, it is crucial to first establish and maintain a strong investment growth. There are two reasons why the increase in investments is necessary. *First*, because the share of investment in Serbian GDP in the entire post-crisis period was structurally very low and insufficient for establishing high economic growth rates. According to the latest EBRD analyses, there is a shortfall in investment in Serbia of about 7% of GDP, annually. *Second,* of all GDP components, only investment can increase relatively quickly and sustainably over the next few years, driving the growth of the entire GDP without disrupting the country's external balance or hazardously increasing public debt.

Investment is exactly the GDP component that kick-started economic recovery with its 10% growth in 2015, which is a good thing. It is also encouraging that investment growth in 2015 is widely spread, encompassing both domestic and foreign investment, showing in both civil engineering but also in the purchase of equipment, which may indicate that this is a more lasting trend, i.e. that Serbia may be departing from its stagnation of several years. However, the period in which this investment growth has taken place is very short (less than a year) and thus not completely convincing, and it should also be kept in mind that even with the growth of investment in 2015, its share in GDP in 2015 will increase only to about 18% of GDP which is still a record low share of investment in GDP in Central and Eastern Europe. This is why it is crucial that the Government continues to encourage this investment growth trend by its policies: 1) by continuing fiscal consolidation to reinforce macroeconomic stability; 2) by improving the investment environment (judiciary efficiency, accelerating permitting procedures, removing administrative and other barriers to investment, protection of competition, corruption prevention, completion of the privatization of the remaining state-owned enterprises, etc.), but also 3) to increase efficiency in implementing public investment which, in the short term, accelerates economic growth, but also incentivize greater private investment in the medium term. On the other hand, an analysis of the investment trends from 2010 to 2015 at a macro level fails to provide convincing arguments that the state subsidies for attracting certain investors have had a significant influence on a lasting increase in investment activities.

A relatively high economic growth (of over 4%) will not be sustainably achievable in Serbia in the upcoming two to three years, as it takes a significant restructuring of the domestic economy, during which it will be impossible to achieve high economic growth rates. The only correct path, or blueprint for a of high and sustainable growth rates in Serbia is: increase in investment, then net export, then employment and private consumption, allowing state consumption to have a more significant growth only at the end. Preliminary analyses show that such a model of economic growth could allow for somewhat higher annual GDP growth (over 4%) from 2018 at the earliest, but it is even more likely that this will happen even later. Alternatives to this scenario, i.e. any skipping of the steps and premature increase in public and private consumption would be very dangerous and could only incur greater harm than good to the economic growth. This is also illustrated by the temporary episodes of increased public consumption that have taken place in the previous few years. Thus, in 2012, state consumption was significantly increased (real growth of about 2.5%), which, however, did not have a significant impact on GDP growth; but 2012 was also the year in which record public debt increase was noted, of about EUR 3 billion.

The economic recovery initiated in 2015, i.e. in the year in which some of the key measures of fiscal consolidation have been implemented (pension and public sector wage cut) indicates, quite convincingly, that fiscal consolidation did not have major adverse effects on economic activity. Discussions on the negative effects of fiscal consolidation on economic activity were a hot topic a year ago, especially on whether the pension and public sector wage cut was worthwhile. Numerous opponents of this policy claimed that it would lead into a deeper recession (than the one Serbian economy was already in) and that the expected deficit decrease would not occur either, being that tax revenues would decrease as the economic activity plummeted further. However, none of this happened. The fiscal deficit was strongly and permanently decreased by about 2.5% of GDP and, instead of the expected continued recession, economic activity started recovering. The most probable economic reasons for the relatively small adverse effect fiscal consolidation has had on Serbian economy (low fiscal multiplier) are: that Serbia is a small, open economy; not a developed country; with flexible currency exchange rate and inflation targeting; as well as high public debt, higher than the theoretical limit set in research (60% of GDP). Although the impact of fiscal consolidation on Serbian economic growth was mildly negative in the short term, its effect on economic activity in medium term is positive – the consolidation was probably one of the key factors that allowed for the observed growth of investment in 2015. Due to the great importance of fiscal consolidation for, high and sustainable economic growth in medium term, it needs to be continued in 2016 and 2017.

In the last three years, there has been an unusually strong growth in employment and drop in unemployment, while the economic activities have been stagnant. The number of employees has increased by about 20% from its lowest level in 2012 by the third quarter in 2015, while the unemployment rate dropped by about 10 pp in the same period. A more in-depth analysis shows, unfortunately, that it is not very likely that such favourable trends have actually occurred, i.e. that the fast growth of employment and drop of unemployment, registered from the end of 2012, are most likely the consequence of unreliable data of the SORS describing the labour market and not the true improvements in economy. The piece of data casting doubt on the official labour market trends is the fact that no country in Central and Eastern Europe has had an even similar growth in employment as Serbia in the last three years (although the majority have had a significantly higher GDP growth). In addition, the strong increase in the number of employees would have had to leave a clear mark on the economy of any country, and there is no such mark in Serbia: the GDP, which is most frequently correlated with employment rates (Okun's Law) has been practically stagnant since 2012; private consumption has dropped, although labour income is the largest individual item driving private consumption; while the fluctuations of contributions and income tax showed absolute inconsistency with the flows of formal employment rates from the Labour Survey. Another indication that the official labour market data is unreliable lies in the fact that immediately prior to the latest increase in employment, Serbia had a non-convincing episode of an enormous decrease in employment of 600,000 people – again not observed in other CEE countries, but also inconsistent with the fluctuations of all related macroeconomic indicators in Serbia. Analyses of indirect indicators of employment trends show that its actual increase in the last three years most likely amounted to only 1%.

The number of employees in Serbia will probably stagnate in the medium term (regardless of the indicators that the SORS will publish). In the upcoming two years, a relatively low economic growth is expected, so GDP could cumulatively grow by about 4% in 2016 and 2017. With the expected employment elasticity with regard to GDP, this would indicate a possible growth in employment of about 2%. However, it is already evident that the number of employees will decrease in the enterprises undergoing privatization, the fate of which is being settled at the moment, and there are significant layoffs announced for the "budget" sector and public enterprises. These layoffs will not have a great effect on the GDP, but will temporarily cause a mild decrease in overall employment. Taking all this into account, including the factors that will cause a mild increase in employment and those that will lead to a mild decrease in employment, it is most likely that the number of employees in 2018 will probably be equal to that from the end of 2015. And the answer to the question of whether there will be a stronger, more sustainable (and this time real) trend of employment increase from 2018, will depend primarily on whether the conditions for a fast, sustainable growth in economic activity will be met in the next two years, i.e. whether the Government will provide the conditions for a strong increase in investments by working on improving the investment environment and successfully implementing fiscal consolidation.

After several unsuccessful attempts to return Serbian public finances to a sustainable path in the period 2012-2014, a new three year fiscal consolidation programme was launched in 2015, supported by an arrangement with the IMF. In the first year of implementation, the results achieved exceeded the expectations – in 2015, the deficit was permanently decreased by almost 2.5% of the GDP (from 6.6% of GDP in 2014 to a little over 4% of GDP), with the largest part of the savings coming from the pension and public sector wage cut and from the increased tax revenue collection (mostly focused on the activities suppressing the bootlegging of oil derivatives and tobacco products). However, in order to stop the growth of public debt by 2017 (eliminating the immediate danger of a public debt crisis), the deficit needs to be permanently decreased to at least 2.7% of the GDP, meaning that additional permanent savings needed in 2016 and 2017 are about 1.5% of GDP. Being that the main austerity measures, such as pension and wage cuts in the public sector, have been exhausted already in 2015 - the remaining savings will have to rely on structural reforms. The problem is that in 2015 these structural reforms were overdue, and there is a great risk that they will not be fully implemented in 2016 and 2017 either.

It was planned that the main leverages for deficit decrease in 2016 and 2017 would be general government rationalization and pension and wage freeze. However, rationalization failed completely in 2015 and it will almost certainly not go according to plan in 2016 and 2017 either. Pensions and wages in the largest part of the public sector were unfrozen already at the beginning of 2016 and it is not very likely that they will not be increased in 2017 again. Due to the premature relaxation and insufficiently prepared measures, there is a significant risk that the structural deficit will remain at the level of 3.5% of GDP in the medium term, which is insufficient for the success of fiscal consolidation. Public debt would continue to increase over 80% of GDP, with a further increase in interest expenditures, and at certain point, public debt crisis would become inevitable – despite the indisputably good fiscal result in 2015.

In addition to all this, the danger from new budget expenses for public and state-owned enterprises has still not been eliminated – and this was the main reason for the failure of all previous attempts at the recovery of public finances. The first steps in resolving the issues of large state-owned enterprises (EPS, Zeleznice, Srbijagas), pertaining to their organisational changes, were made in 2015. However, the true test will come with the layoffs of a large number of redundant employees, increase in prices, collection improvement, etc., which has yet to take place in its full scope. Completion of the privatization process in the prescribed time frame (by mid-2016) will also present a great challenge. Looking at the number of enterprises, the majority have had their status resolved in 2015 – but these were smaller enterprises. In terms of the number of employees, two thirds of the original number are still employed by the enterprises still owned by the state. The greatest problems pertain to the resolution of the status of those enterprises that are incurring losses but are classified among the strategically important enterprises (RTB Bor, Petrohemija, Resavica, etc.) as well as Zelezara Smederevo. At that, there are already some hints that the Government may opt for some transitional solutions that would be unsustainable in the long-term for many of them (predesigned restructuring programmes, their merger with public enterprises or the reversal of privatization), so the unsuccessful business operations of these companies may again become a direct (or indirect) budget expenditure in the future. On the other hand, a more efficient suppression of grey economy could provide important support to the initiated fiscal consolidation, but this would take systemic measures and a thorough reform of the Tax Administration.

The rest of the paper is organized as follows. In the next section we analyse recent macroeconomic trends and sustainability of the initiated recovery, investment growth and impact of fiscal consolidation on GDP. In the third section we are arguing against the credibility of official data on strong improvemnts in the Serbian labour market in recent years. In the fourth section we discuss the scope of recently implemented fiscal consolidation programme and the greatest challenges that lie ahead.

Economic trends: Sustainability of the initiated recovery, investment growth and the impact of fiscal consolidation on GDP

Is the investment growth in 2015 a hint that stagnation is about to end, after several years?

Serbia is one of the rare countries in Central and Eastern Europe that has not managed to establish and sustain economic recovery after the eruption of the world economic crisis (2008 and 2009) until 2015. Instead, temporary episodes of mild recovery were interrupted, as a rule, by new recessions – of which there were two in Serbia after the first crisis wave had passed. A consequence of such economic trends was that Serbia (along with Croatia and Slovenia) remained in the small group of CEE countries which have failed to reach the level of their economic activity from 2008, even after 2015 (see Table 1).

Table 1: Central and Eastern Europe – Cumulative GDP growth, 2008-2015

	GDP 2015/GDP 2008
Poland	123.6
Albania	118.5
Macedonia	115.3
Slovakia	111.0
Estonia	105.4
Montenegro	105.3
Czech Republic	103.7
Bosnia and Herzegovina	103.4
Lithuania	103.2
Romania	103.0
Bulgaria	102.4
Hungary	102.3
Latvia	100.0
Serbia	99.0
Slovenia	95.3
Croatia	88.2
Weighted average	110.2

Source: The author's calculations based on the data from IMF WEO database (October 2015 update)

From the second quarter of 2015, Serbia has again entered a period of economic recovery, which we analysed in more detail. The main question we attempted to answer was: can the initiated recovery be sustainable this time and thus represent a basis for further acceleration of economic activity in medium term, or is it just another episode of interim recovery, already seen in the period from 2010 to 2015? In addition, relying on the results of analyses of the trend and structure of the recovery that began in 2015, we have taken a preliminary look at the perspectives of economic growth in the upcoming years and provided a first assessment of the influence of fiscal consolidation on economic growth.

The analysis indicated three important findings: *first*, this time it may actually be possible that the economic growth from 2015 will be sustainable, as it is driven by a widespread investment growth (unlike the previous hints of growth), but that there are still many uncertainties that may jeopardize the initiated economic recovery; *second*, that 2016 and 2017 will not be years of dynamic economic growth and that such growth (exceeding 4%) can hardly be expected even in 2018, as it will take several years to resolve the largest structural issues of the domestic economy and initiate a more significant, sustainable recovery in private consumption; and *third* that the fiscal consolidation process from 2015 had a very small negative impact on short-term deceleration of economic activity but that, all things considered, it had formed a good prerequisite for the gradual acceleration of economic growth in medium term. For this last reason, we emphasize the continuation of fiscal consolidation in the upcoming years as one of the important, or even crucial prerequisites for the establishment of a lasting economic recovery and its gradual acceleration, – which will represent a great challenge for the Government, as shall be seen in the third chapter of this paper.

While analysing economics activity, we have made a distinction between lasting and temporary trends. The majority of oscillations in economic activity during 2010-2015 period were caused by external factors: 1) drought in 2012 and 2015, caused a sharp temporary drop in agricultural activity in those years but consequently, it fuelled growth in the following years (expected again in 2016), as agricultural production returned to its usual level and 2) floods from 2014, which due to the coal mine flooding lead to a drastic temporary drop in electricity production during 2014 and consequently, an equally drastic recovery of the sector in 2015, when normal production of coal and electricity were reprised. Economic trends adjusted for temporary shocks are shown in the second column in Table 2.

The second column of Table 2 shows that from 2010 to 2015, if one-offs are excluded, economic activity was in a relatively stable stagnation – i.e. it achieved an almost negligible average annual growth of 0.3%. In addition, these "purified" growth rates in the observed period did not oscillate much from year to year (staying in a relatively narrow range of -1% in 2004 to 1.4% in 2011). We hence believe that economic stagnation is the lasting, structural trend of the national economy that has practically been present the whole time since the start of the first crisis wave in 2008 and 2009. The table also shows that no significant growth is expected in 2016 either – as a large part of the predicted 1.8% growth is a consequence of agricultural production recovery after a drought.

A somewhat more detailed analysis of Serbian GDP structure reveals that an insufficient level of investment since 2010 is the reason behind the economic stagnation. Its share in the GDP, which is well below 20% of GDP (average level of investment in the period 2010-2014 was 18.5% of GDP[1]) is insufficient to drive economic growth. In the period before the crisis (2003 to 2008), when the average GDP growth rate was about 5.5%[2], the ratio of investment to Serbian GDP was about 22%. In addition, in other comparable CEE countries showing, on average, significantly faster economic growth than Serbia, average investments in the period from 2010 to 2014 were 4 pp higher than in Serbia, i.e. 21.5% of GDP. In its *Transition Report* for 2015-16 [2], the EBRD provided a somewhat more precise quantification of the lack of investments in Serbia. According to this analysis, after the crisis, Serbia has shown a structural investment deficit of 7% of GDP, which is higher in comparison to the investment deficit present in other European economies in transition (see Figure 1). This data and analyses indirectly indicate that the investment climate in Serbia is significantly worse than that of the comparable CEE countries, as Serbia has been lagging behind them in terms of investment levels for quite a few years.

The very low level of investment is not the only reason why its strong growth is a key prerequisite for a lasting, sustainable departure of Serbian economy from stagnation. There is currently no other GDP component which could keep increasing sustainably for a number of years, directly driving the overall GDP growth in the medium term. Serbian GDP's structure is such that it is dominated by overconsumption (personal and state), the share of which in the GDP will have to be decreased in medium term, i.e. it is certain that consumption cannot serve as a sustainable engine of growth in the upcoming years. The actual room for a more permanent acceleration of economic activity,

1 With certain oscillations from time to time, the investment trend in Serbia was markedly decreasing, so that by 2014, the share of investments in the GDP dropped down to a mere 16.7% of the GDP, making Serbia the absolute negative record holder among all CEE countries (the next on the list, BH, showed a share of investment in the GDP of 18.3%).

2 We would like to emphasize that this economic growth rate would not be completely sustainable even if the world economic crisis had not occurred, as it was achieved with a large increase in external imbalance (the current account deficit exceeded 20% of GDP immediately prior to the crisis)

Table 2: GDP growth in Serbia excluding one-off factors, 2010-2016

	GDP growth (%)	GDP growth (%), excluding one-offs	Agriculture (contribution to GDP growth pp)	Floods (contribution to GDP growth pp)
2010	0.6	0.1	0.5	-
2011	1.4	1.4	0.1	-
2012	-1.0	0.5	-1.5	-
2013	2.6	0.5	2.1	-
2014	-1.8	-1.0	0.2	-1.1
2015	0.8	0.5	-0.8	1.1
2016*	1.8	1.1	0.8	-

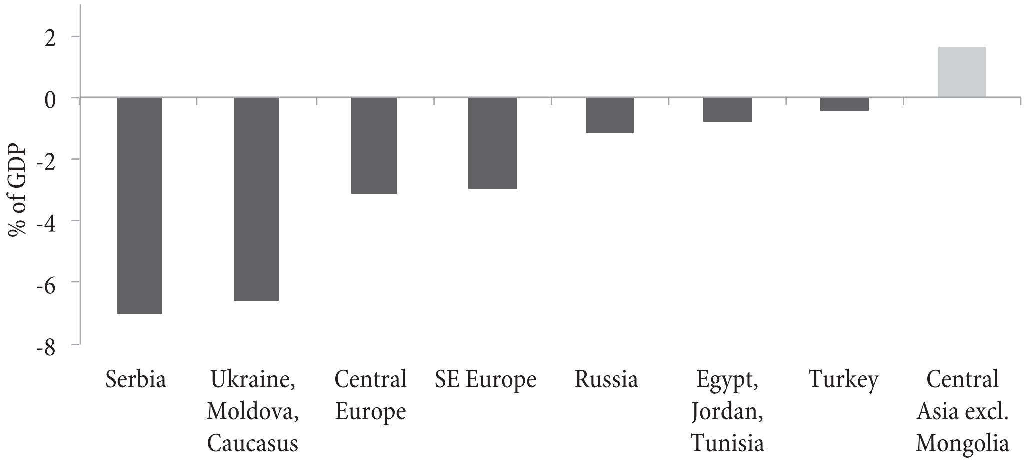
*Official forecast (used for the preparation of the budget and Fiscal strategy)
Source: The author's calculations based on the data from the Statistical Office of the Republic of Serbia

which would also mean the end to stagnation, lies in the growth of net export and investment, with investment being particularly important. This is because export growth based solely on the existing, unused capacities is possible only in a very limited time period; for economy to be able to rely on the growth of net export permanently, it would be necessary to first *invest* into new production capacities (aimed at the production of tradable goods).

Investment, therefore, has a twofold effect on GDP growth: in the short term, they increase demand and directly influence GDP growth and in the medium term, on the supply side, they increase capacities for production and net export growth. Therefore, once investments have increased, the next GDP component that should consequently show stronger growth is net export, which in turn would lead to a stronger growth in private sector employment and increases in private consumption, and only in the end, government consumption could increase as well. Actually this is the only possible order of events that would allow for a dynamic, sustainable growth in the excess of 4%, which due to the structure of Serbian GDP can only be achieved in practice when all, or at least three components of the GDP (investments, net export and personal consumption) show growth.

In 2015, investment showed a high growth of almost 10%, more than any other GDP component, which is good. However, this is still not a certain indication that Serbian economy is on its road to recovery and gradual establishment of sustainable, high growth. The period in which this investment growth has taken place was very short (less than a year) and thus the growth is not completely convincing. Moreover, it should also be kept in mind that even with the growth of investments in 2015, their share in the GDP will increase only to about 18.1% which is still the lowest share of investment in GDP in Central and Eastern Europe. However, we believe it is very important that this time (unlike the previous episodes of temporary, unsustainable investment growths after the crisis) the investment growth

Figure 1: Transition economies – Estimated investment surplus/shortfall



Source: [2]

is widely spread, encompassing both foreign and domestic investments, it is visible in construction sector but also in the purchase of equipment – fuelling hope that it is of a more permanent nature.

Construction activities, following a poor first quarter, show a high year on year growth in the second and third quarters, of about 15%. Growth of newly approved loans to businesses, coming from the domestic banking system, has started to pick up in the second half of the year. Domestic production of capital goods in 2015 increased by 3% in comparison to 2014, while the import of capital goods also increased by about 3% relative to the previous year. Foreign direct investments (FDIs) were very low until May 2015, even lower than the inadequate level from 2014. However, after May, FDIs accelerated strongly, so that by the end of November 2015, they not only reached their level from the period of January-November of the previous year, but exceeded it by almost 50% (i.e. about EUR 500 million). In addition, the growth of total investments in 2015 of almost 10% is primarily the consequence of the increase in private investments, as the state showed only a slight increase of its already low efficiency in execution of public investment.

Although it is still too early to discuss the causes of such a widely spread private investments increase in 2015, it is highly likely that it was strongly affected by the improved business environment in the previous year. Some reform laws have been adopted, such as Labour Law, Law on Planning and Development, there has been a global drop in interest rates, ECB opted for an expansive monetary policy, EU economies and economies of the countries in the region have started recovering, etc. Perhaps the crucial change in 2015, which, we believe, could have had an effect on the growing trend of investments during these two years is fiscal consolidation – as it is very difficult to expect investment growth in a country threatened by a public debt crisis.

We believe that all these factors constitute significant differences of the investment increase in 2015 compared to other episodes of their temporary growth, such as in 2011 and 2012, which is why we believe this trend could prove longer lasting and more sustainable. The temporary increase of investments in 2011 and 2012 was similar in its intensity to the one from 2015, but its structure was significantly different. The only branch in investments that showed a strong growth back then was the import of specific industrial machines (which increased by as much as 67% only in 2011, when compared to 2010, i.e. by EUR 336 million), while the growth of other types of investments was much lower – for example, civil engineering showed a cumulative decrease of about 4% in 2011 and 2012. Such trends show that the investment growth was not a general trend, distributed throughout the economy, but rather focused on just a few large companies (FIAT, NIS). When these two companies completed their investment cycle, the level of investments returned to its previous level and economic activity sunk back into recession at the end of 2013, and stayed in there until the new investment increase in 2015. It is interesting to note that the investments of FIAT and NIS were related to direct state interventions (subsidies and privatization).

The main conclusion of this part of the analysis would be that, due to positive and widely spread trends in investment flows, it is possible that the economic activity recovery begun in 2015 could be sustainable, i.e. represent a good base for further acceleration of economic growth and that unlike all the episodes in previous 6 years, the Serbian economy now truly has a chance to exit its long stagnation. This, however, has not yet been guaranteed, which is why the Government has a serious task of maintaining and encouraging this investment trend, i.e. strengthening macroeconomic stability by means of fiscal consolidation, resolving key issues due to which the investment environment in Serbia is poor (judicial efficiency, acceleration of permit procedures, elimination of administrative barriers to investments, protection of competition, prevention of corruption, etc.) but also to increasing efficiency in the implementation of public investments that stimulate economic growth in the short term, as well as encouraging higher investments from the private sector in the medium term. If the Government gives up on these policies, it is quite evident that the recovery initiated in 2015 will prove to be short lived. Another conclusion that could be drawn from this short analysis is that direct state interventions in attracting (and paying for) individual investors are probably not the optimal model for a sustainable investment increase and economic recovery, as they are too focused, temporary and also come at a price that could question their justifiability; in addition, there were hints of certain abuses (firing, then rehiring the same employees).

Structural changes in the GDP: Prerequisite for its growth past 4%

We have described the blueprint for establishing a sustainable and dynamic economic growth in Serbia (first, by increasing investment, then net export, followed by private consumption and in the end, public consumption) and it is possible that we are now seeing the first outlines of this blueprint taking shape – which the Government should endorse and strengthen using the adequate policies. Knowing this, the next important question is: when is the earliest that, under ideal circumstances (good policies) a lasting economic growth of at least 4% could be achieved, allowing Serbian economy to converge to the more developed EU economies? The answer to this question is that it will take some time, as significant changes in the structure of Serbian economy first need to take place, during which it will not be possible to achieve high growth rates. This is why a relatively strong economic growth (over 4%) will not be possible in the upcoming two years (prior to 2018), but it is somewhat more likely that it will take place even later. The focus, once more, is on lasting and sustainable dynamic economic growth, because even if by some chance (by increasing public and private consumption) a relatively high GDP growth was to be achieved prior to 2018, such a growth would be temporary, or even very dangerous.

If, in the medium term, the investment growth continues at 5-10% per year (which is still not definite), due to the small share of investments in the GDP – which at the moment is well below 20% – this could only contribute 1.5% to the GDP increase. It is not very likely that net export could provide the additional annual 2.5 pp of GDP in the first years of recovery needed for the overall economic growth of 4%, as this would mean the decrease in trade deficit in a period of several years by about EUR 850 million per annum. Therefore, the prerequisite for GDP growth in excess of 4% is the growth of at least three out of four GDP components (investments, net export and public consumption). Even more precisely, for a high and permanent growth of Serbian GDP, it will take an increase in private consumption of at least 1.5% which would have to be preceded by several years of investment and net export increase. Being that such a change in GDP structure cannot occur prior to 2018, and likely not even in 2018, it provides the answer to the question of when is the earliest possible time to expect the first significant growth of Serbian economy. We emphasize, once more, that the alternatives to this scenario, i.e. any avoidance of the steps and early increase in public and private consumption would be very dangerous and could only incur greater harm than good to the economic growth. This is best illustrated by the temporary episodes of increased public consumption that have taken place in the previous few years. Thus, in 2012, state consumption was significantly increased (real growth of about 2.5%), which, however, did not have a significant impact on GDP growth; but 2012 was also the year in which record public debt increase was noted, of about EUR 3 billion.

Fiscal consolidation and economic growth lessons from 2015

Finally, the last topic of this preliminary analysis of main economic trends from 2015, which we are undertaking, is: what does 2015 say about the impact of fiscal consolidation on Serbian economic growth? Discussions of the negative effects of fiscal consolidation on economic activity were a hot topic a year ago, especially on the issue of whether the pension and public sector salary cut was worthwhile.[3] Numerous opponents of this policy claimed that it would lead into a deeper recession (than the one Serbian economy was already in) and that the expected deficit decrease would not occur either, with tax revenues decreasing as the economic activity plummeted further. However, none of this happened. The fiscal deficit was strongly and permanently reduced by about 2.5% of GDP and, instead of the expected recession, economic activity started recovering.

3 Authors of this paper also contributed to these discussions. One of the papers showing that fiscal consolidation was necessary and that its impact on economic activity was very small was published in this very journal two years ago, see [8].

A relatively small negative impact of fiscal consolidation on economic growth should not be a surprise, due to the specific traits of Serbian economy. Fiscal consolidation impact on the reduction of economic activity is measured by the fiscal multiplier, which is significantly lower – as expected – for Serbia than for more developed European countries. The reasons are: that Serbia is a small, open economy; not a developed country; has flexible currency exchange rate and inflation targeting; as well as high public debt, higher than the theoretical limit set in research (60% of GDP). On the other hand, the fiscal multiplier is somewhat larger in recession, in which Serbian economy was at the beginning of fiscal consolidation. Taking into consideration all the specific traits of Serbia and the economic cycle, it was expected that Serbian fiscal multiplier would be relatively low, 0.5 at most. This would mean that for 1% of GDP decrease in deficit, the economic growth would slow down by less than 0.5 pp in the short term. The somewhat better than expected economic results in 2015, support theoretical predictions of a low fiscal multiplier in Serbia and perhaps indicate that it is even lower than initially expected. Still, at the time being, more reliable and precise analyses of the impact of fiscal consolidation on economic growth are not yet possible as not all macroeconomic indicators for 2015 are yet available, and there needs to be a consideration of additional specific traits of the implemented fiscal consolidation, which can substantially modulate its impact on economic activity – since the fiscal multiplier is different for public revenue and public expenses, higher for public investments than other forms of public consumption, etc.

Although the fiscal consolidation has a lower, more limited negative impact on economic activity in Serbia in the short term, in the medium term it has a positive effect on economic growth. Fiscal consolidation was probably one of the more important factors that have allowed for the observed investment growth in 2015. In a country facing a realistic danger of public debt crisis and macroeconomic instability, strong increase in investments is not very likely, and it was fiscal consolidation that shifted Serbia away from this unfavourable scenario. This can be indirectly substantiated by the comparative analysis of FDI trends. Comparing FDI growth in Serbia and other comparable countries, we can see that it was Serbia that achieved the greatest FDI growth in 2015 compared to 2014. It is even more interesting that this FDI growth in Serbia took place only from the second half of the year, when first positive results of the fiscal consolidation became indisputable.

Fiscal consolidation is thus a good, probably even crucial, policy for the establishment of a sustainable, high economic growth in medium term – and it needs to continue in 2016 and 2017. This is because the only way to have a long-term investment growth, which is crucial for the establishment of a sustainable economic growth pattern, is to stop the increase in public debt and ensure public finance recovery. There are, however, numerous challenges and risks that can prevent the implementation of fiscal consolidation in the upcoming years, which could annul its indisputable good results from 2015, potentially jeopardizing the economic recovery in medium term. These risks and challenges will be analysed in more detail in the third chapter of this paper.

Strong employment growth in a stagnating economy: An illusion, after all

High unemployment is one of the greatest structural problems of Serbian economy. According to the latest available data, from the third quarter in 2015, the unemployment rate in the population of 15-64 was 17.3%, which is among the highest unemployment rates in Europe.[4] However, in the last two years, there has been an unusually strong growth in employment and drop in unemployment, while the economic activities have been stagnant. The number of employees has increased by about 20% from its lowest level in 2012 to the third quarter in 2015, while the unemployment rate dropped by about 10 pp in the same period. A more in-depth analysis shows, unfortunately, that it is not very likely that such favourable trends have actually occurred, i.e. that the fast growth of employment and drop of unemployment, registered from the end of 2012, are most likely the consequence of unreliable data of the Statistical Office of the Republic of Serbia (SORS)

4 Of 47 European countries for which data exist, only six have a higher unemployment rate than Serbia (Albania, Bosnia and Herzegovina, Croatia, Greece, Macedonia and Spain)

describing the labour market and not indicative of true improvements in economy.

The first information casting doubt on the official labour market trends is the fact that no country in Central and Eastern Europe has had an even similar growth in employment as Serbia in the last three years (although the majority have had a significantly higher GDP growth). However, this is not the only, or even the main argument showing that the positive labour market trends in the recent years are but a statistical illusion. The strong increase in the number of employees would have had to leave a clear mark on the economy of any country, and there is no such mark in Serbia: the GDP, which is most frequently correlated with employment rates (Okun's Law) has been practically stagnant since 2012; private consumption has dropped although income from work is the largest individual item driving private consumption; while the trends of income tax and contributions showed absolute inconsistency with the trends in formal employment rates from the Labour Force Survey (LFS). Finally, another indication that the official labour market data are unreliable lies in the fact that immediately prior to the latest increase in employment, Serbia had a non-convincing episode of an enormous decrease in employment in the period 2008-2012, again not observed in such intensity in other CEE countries, but also inconsistent with the trends of all related macroeconomic indicators in Serbia.

Table 3 shows the official data on the trends of employment and unemployment rates in Serbia since 2008. There are two distinct sub periods: *the first*, from 2008 to 2012, in which employment sharply decreased by about 600,000 people and unemployment rate went from 14.4% to 24.6%; and *the second*, from 2013 to 2015, in which employment grew significantly by over 330,000 people and the unemployment rate dropped down to 18.5%.[5] These data already stir doubts about their validity, being that the changes in the number of employees and unemployment rate are huge and macroeconomically unusual.

Table 3: Serbia – Number of employees and unemployment rate, 2008-2015[6]

	Number of employees	Unemployment rate (15-64)
2008	2,821,724	14.4
2009	2,616,437	16.9
2010	2,396,244	20.0
2011	2,253,209	23.6
2012	2,228,343	24.6
2013	2,310,718	23.0
2014	2,544,188	20.1
2015	2,558,426	18.5

Source: Statistical Office of the Republic of Serbia, LFS
Note: the data for 2015 represent the average of the first three quarters, for which the data is available

Although this paper primarily deals with the evaluation of the growing employment trend started in 2012, we will take a brief look at the period from 2008 to 2012, when unemployment showed a pronounced growth and employment a sharp drop (by almost 600,000 employees). Such a marked drop in the number of employees is problematic for several reasons. First of all, this is an enormous number of people. The fact that education, healthcare, army and police employ a total of 400,000 people can serve as a good illustration of just how many people had lost their jobs, according to the official statistics. A drop of employment by 600,000 people would have inevitably meant that Serbian economy was plummeting. In addition, a similar drop in employment during the crisis has not been recorded in any other CEE country – even though some have recorded a double-digit drop in GDP (in Serbia, the GDP drop in the period 2008-2012 amounted to 2.2%). To make matters even less convincing, the enormous employment decrease in Serbia did not take place across the board, i.e. it occurred practically exclusively in the private sector, as the public sector kept an almost unchanged number of employees.[7] One of the specific traits of Serbian economy is a greater

5 This is the average number of employees and average unemployment rate from the first three quarters of 2015. The last available data for Q3 in 2015 show that the number of employees in Serbia increased even further, to 2,615,221 and unemployment rate decreased to 17.3%. These last numbers were used in the introduction to this chapter to illustrate the magnitude of change on the labour market, where we compared them to the minimal number of employees of 2,157,618 and the highest unemployment rate (15-64) of 26.1% achieved in 2012.

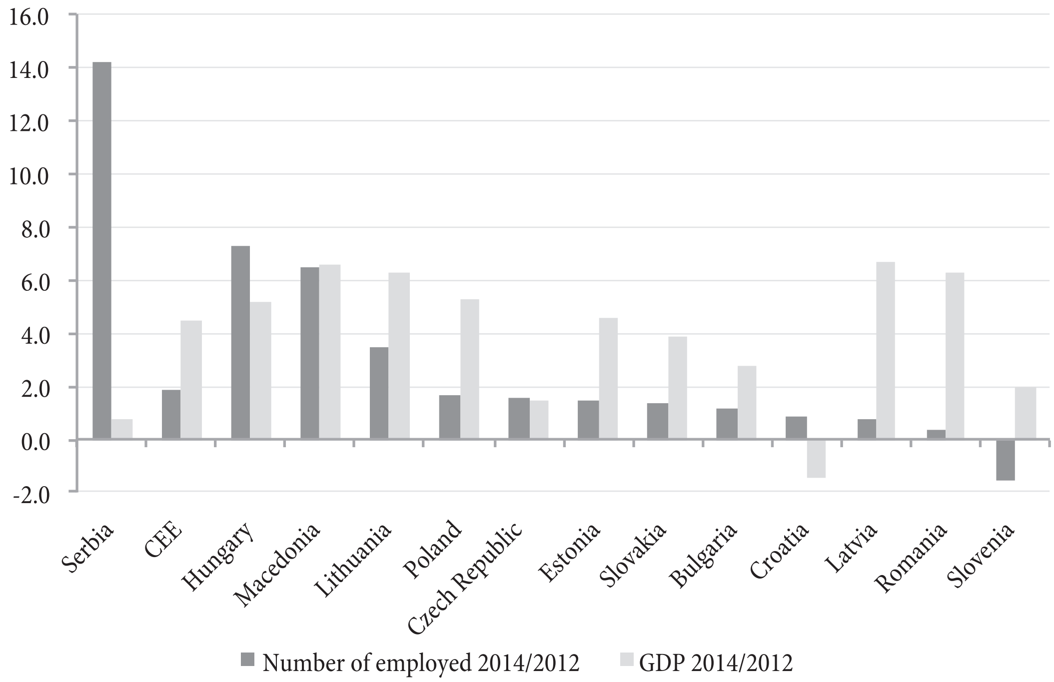
6 We chose to use total employment rate in the population over 15 years old as the indicator of overall employment trends, and for unemployment rate, the population from 15 to 64 years of age only, because these indicators allow for international comparability (unemployment rate) and a better correlation with the other related macroeconomic aggregates (overall employment).

7 This can easily be shown by the analysis of fiscal expenses for employees, financial reports of public enterprises and the portfolio of the Privatization Agency as well.

participation of the public sector in the overall economy, compared to other similar countries.[8] There are about 750,000 people working for the state (about 500,000 directly and about 250,000 more in public and state-owned enterprises). This means that the decrease in the number of people employed by about 600,000 had to have happened in a much smaller sample of about 2 million employees and not in the total number of 2.8 million employees which was the total tally in 2008, including the public sector. An attempt to provide an economic explanation of such unusual trends in the labour market [1] alleges the existence of superfluous employees as the Serbian economy undergoes a transition, meaning that the employment could drop more than production itself. However, even though it is likely that there are certain transition surpluses in the number of employees in Serbia, this can hardly account for the fact that the private sector, ten years from the beginning of the transition, laid off almost a third of its employees in the conditions of a not-so-deep recession – it is almost certain that these were actually grave errors in the estimates of employment numbers by the SORS. We are emphasizing the episode of employment decrease in Serbia from 2008 to 2012 to show that there is a systemic problem in SORS's monitoring of employment, which means that poor recording of trends in the previous three years would not be a precedent.

Figure 2 shows employment and GDP trends in Serbia and other Central and Eastern European countries for the period 2012-2014.[9] In this period, Serbia had by far the greatest employment growth of over 14%, which is twice as large as the next comparable country. At the same time, Serbian GDP was below average. By looking at the entire group of the countries (excluding Serbia), employment grew in CEE by 1.9% in the period 2012-2014, while the GDP increased by 4.5% (see Figure 2). This means that the elasticity of employment with respect to GDP in the CEE in the observed period amounted to 0.42, which is completely in line with theoretical expectations of employment elasticity, which is in the range of 0 to 1.[10] Employment elasticity by individual countries (excluding Serbia) shows certain discrepancies from this average elasticity. Thus, Slovenia had the smallest employment

Figure 2: Central and Eastern Europe – Employment and GDP growth, 2012-2014



Source: Eurostat
Note: no data available for Montenegro, Bosnia and Herzegovina and Albania

8 In transition countries of the CEE, the average share of the public sector in the GDP in 2010 was 27.5% and in Serbia it was 40%. Source: Structural change indicators, EBRD, 2010.

9 Comparable data at the annual level for 2015 have not been published yet, but the data from the first three quarters show that similar trends continue in 2015.

10 Employment elasticity shows the percentage of change in employment with 1% change in GDP.

Table 4: Serbia – Nominal growth of contributions and total wage bill, 2012-2015

Formal employment growth (2015/2012)	Average salary growth (2015/2012)	Nominal growth of wage bill (2015/2012)	Nominal growth of contributions (2015/2012)	Difference
12.1%	6.5%	19.3%	7.5%	12.8 pp

Source: SORS (Labour Force Survey), Ministry of Finance
Note: Contributions growth was adjusted for the change in the contributions rate in 2013

elasticity with respect to GDP found in CEE, in the amount of -0.8 (employment drop of -1.5% with GDP growth of 2%), while the greatest elasticity was observed in Hungary, amounting to 1.42 (employment growth of 7.3% with GDP increase of 5.2%). Empirical research shows that, in the short term, a certain departure from the theoretical boundaries of employment elasticity (0-1) is possible, so these results are completely expected. However, employment elasticity in Serbia amounts to 19.9 which is far outside the expected, and indeed, any possible range.

As was already mentioned, employment rate changes leave a distinct trace on the trends of other macroeconomic aggregates. An indicator directly dependant on employment trends is contribution collection, as the base for the collection of contributions is the total amount of salaries (wage bill) in formal economy (the number of formally employed multiplied by the average salary).[11] Contributions growth would therefore, by definition, have to be approximately equal to the growth in the total amount of salaries, i.e. the increase of the number of people formally employed and their salaries. However, this was not the case in Serbia. In Table 4, we showed the increase in total salaries and increase in contributions in the previous three years (2012-2015), showing a nominal growth in contributions of 7.5% while the nominal increase in total salaries, influenced by the great increase in the number of employees, amounted to as much as 19.3%. Seeing as how these two indicators should be nearly identical and the contributions collected represent an exact piece of information – the only possible explanation for the discrepancy lies in poor measurement of employment trends in the LFS.[12]

We shall now pay a little more attention to the data from Table 4. It can be observed that the increase in contributions collected corresponded, i.e. was slightly larger than the average salary increase. This indicates that formal employment increased by 0.95% in the period 2012-2015 and not by the (not very likely) 12.1% as indicated by the LFS. This result is especially interesting if we consider that the GDP increase in the period 2012-2015 amounted to 1.5%, as it would actually mean that the real formal employment in Serbia did grow in line with GDP trends, i.e. that employment elasticity in Serbia is approximately 0.65. This would be completely in line with economic theory and employment elasticity in all other countries of the CEE.

The explanation for the growth of total salaries in Serbia being faster than the trends of contributions collected that was offered was that this is partially the consequence of increase in the share of part-time labour in the overall employment [1]. The main problem with this explanation, however, is that the increase in the share of part-time employment would also simultaneously decrease the average salary. Thus the product of the number of employees and their average salary would not be able to accelerate "artificially" if the number of employees who were being paid less increased, thus making the total amount of salaries grow faster than the total contributions collected. On the contrary, the influence of the increase in the share of part-time employment on contributions trends would be exactly the opposite of the one described – it would lead to a faster, not slower growth in contributions in relation to the growth of total salaries. The Law prescribes the lowest salary base for contributions at 35% of the average salary,[13] regardless of the actual salary. This means that if the number of less paid jobs with part time employment increases, the contributions paid will be disproportionately larger – leading to a faster, not slower growth in contributions collected when compared to the trends of total salaries.

11 In this case, only the data on formal employment from the LFS are used, as those employed in the informal sector pay no contributions.

12 Nominal growth of the average salary is not suspicious as it is consistent with inflation and the decrease in salaries in the private sector in November 2014.

13 Law on Social Security Contributions

The second problem with this explanation is that the number of employees in part-time employment amounts to only 10% of the total number of employees, so even an extreme change in this parameter (with the necessary requirement of it acting in the direction opposite to the one it actually acts in) would not explain the difference of almost 13 pp between the contributions collected and the trends of total salaries.

The last discordant indicator we analyzed in detail, directly relating to the employment trends are private consumption trends. Real private consumption has decreased by 2.5% from 2012 to 2015. However, the largest individual component funding private consumption is the total amount of salaries, which showed a real growth of about 10% in the same period, according to the SORS data.[14] Other sources of funding private consumption (pensions, welfare, consumer loans, remittances, etc.) did not decrease nearly as much in the period of 2012-2015 to account for such a drop in overall consumption with such employment growth (some of these sources have even increased). Perhaps it is simpler to explain the discrepancy between consumption and the official data on employment trends by taking a step back from the standard economic indicators. According to the data from the LFS, the number of employees in a country with a total of 2.5 million employees has increased by about 330,000. Such a number of newly employed would have to have a significant effect on the increase in overall consumption in the country, which did not occur – instead of growing, consumption dropped. Finally, it is interesting to note that private consumption trends and the sources funding it imply that the employment most likely increased by about 1% in the period 2012-2015 (just as indicated by contributions trends) and not by more than 14%, indicated by the LFS.

In the end, we would like to point out that the data on the trends of the number of employees from the Labour Force Survey indicated that in 2015, the following sectors showed growth: state administration and defence, mandatory social insurance, education and healthcare; which encompass about 500,000 employees employed by the state and for which it is reliably known that their number actually decreased in 2015, rather than increased. The explanation offered by the SORS as to why LFS data for this sector show trends opposite to the real ones was that the data on employment by activity were unreliable by definition, due to small sample groups. This explanation, however, would only stand for relatively small sectors of up to several dozen thousands of employees, in which small changes in the estimation of the work force can make a difference in the trend, while not having a significant effect on the overall employment trend. This explanation, on the other hand, cannot be valid for a large entity comprising a total of about 500,000 employees, i.e. the errors in trend assessment on such a large sample show very clearly that the LFS data are unreliable and have to affect the total employment trends estimate. From the second half of 2015, SORS stopped publishing data on employment trends by individual activities.

Systemic issues in the official statistics of employment trends do not only hinder the more detailed structural analyses of important macroeconomic trends, but also create practical issues for economic policy which does not have at its disposal some of the most basic economic indicators - how many people are actually employed in Serbia and what are the actual trends on the labour market. Budget projections of contributions and income tax, as well as consumption projections in Serbia are still being developed without the inclusion of suspicious trends from the official labour statistics, which is the only solution possible at the moment, but it is not a good solution. Due to the great significance of reliable monitoring of trends in the labour market, the SORS should carefully reconsider the data from its employment statistics and revise the existing data series in line with the findings. There are hints that such processes are underway, being that in October 2015 there was a correction of the data from the LFS for 2014. This review, however, only brought the estimates of the number of employees from 2014 closer to those from 2015, but failed to correct the main issues in data quality from the Survey or to encompass the previous years, packed with inconsistencies.

14 Table 4 shows that the total amount of salaries of formally employed increased nominally by about 20% from 2012 to 2015, and as the growth of employment in informal economy was even faster, the total amount of salaries could only have grown even more. In the observed period, inflation was about 11%.

The actual employment trends will probably be stagnant in medium-term (until 2018), regardless of the indicators which will be published by the SORS. Namely, in the upcoming two years, a relatively low economic growth is expected. Cumulatively, the GDP could increase by about 4% in 2016 and 2017, which would then, with the standard employment elasticity, indicate a possible growth in employment of about 2%. However, it is already evident that the number of employees will decrease in the enterprises undergoing privatization, the fate of which is being decided at the moment, and there are significant layoffs announced for the general government sector and public enterprises. These layoffs will not have a great effect on the GDP, but will temporarily cause a mild decrease in overall employment. Taking all this into consideration, including the factors that will cause a mild increase in employment and those that will lead to a mild decrease in employment, it is most likely that the number of employees going into 2018 will probably be equal to that from the end of 2015. And the answer to the question of whether there will be a stronger, more sustainable (and this time real) trend of employment increase from 2018 will depend primarily on whether the next two years see the creation of conditions for a fast, sustainable growth in economic activity, i.e. on whether the requirements for a strong increase in investments are met.

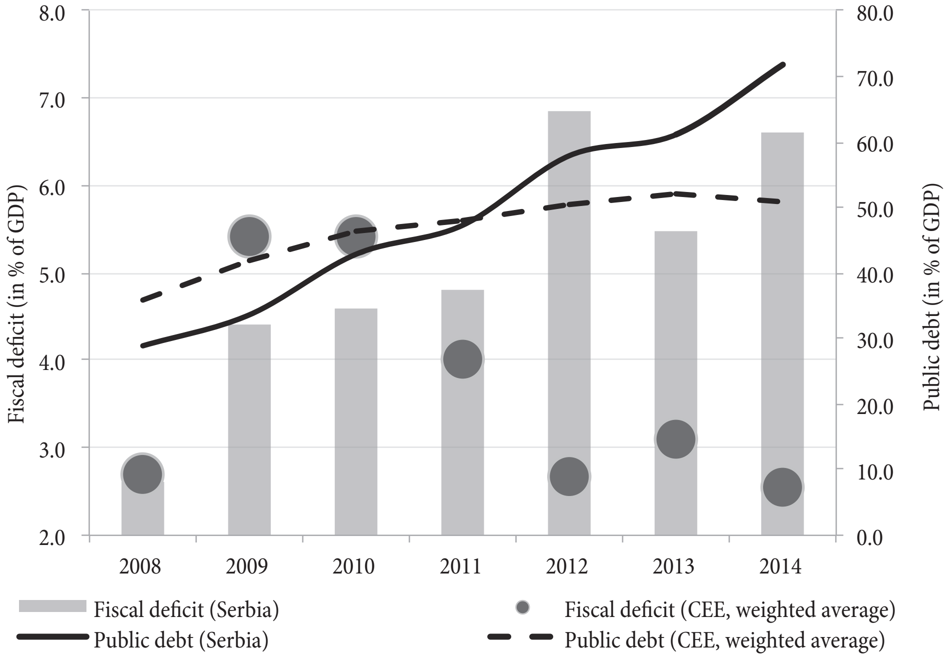
Jump-start of fiscal consolidation in 2015, but great challenges remain

After the world economic crisis broke out in autumn 2008, public finances in the majority of Central and Eastern European (CEE) countries found themselves facing similar problems – sharp deceleration of economic activity lead to a severe drop in public revenue, which in turn lead to an increase in fiscal deficit and accelerated public debt growth. Even though Serbia was no exception, its public finances proved to be somewhat more resilient in comparison to the region, in the early years after the crisis broke out (2009-2010). Figure 3 shows the fiscal deficit and public debt trends in Serbia and other CEE countries, clearly demonstrating that Serbian deficits were evidently smaller until 2010, with the level of debt also below the regional average (although also increasing). As a response to the strong deterioration of fiscal trends, many CEE countries started and successfully completed ambitious fiscal consolidations already in this period, halting the growth of public debt, while the average deficit in the region was decreased to below 3% of GDP by 2012. However, at first, there was no resolute response of the economic policy in Serbia to the public finance challenges brought on by the crisis. From the second half of 2012, there have been several attempts to reign in public debt and decrease the deficit by raising tax rates and limiting expenditures for salaries and pensions, but they proved unsuccessful. The austerity measures undertaken were insufficiently harsh to eliminate the existing structural imbalance between public revenue and expenditure and a high price was paid for the delays and neglect of the necessary reforms (primarily in state-owned enterprises). As a consequence, by the end of 2014, fiscal deficit had increased to 6.6% of GDP (the largest in CEE) and from a country with an average debt, Serbia became one of the most heavily indebted countries in the region – the public debt increased by the enormous 43 pp of GDP from 2008, reaching almost 72% of GDP.[15]

To prevent a potential public debt crisis, a new three-year fiscal consolidation programme was launched at the end of 2014, this time supported by an arrangement with the IMF. The main objective of this programme is to stop the growth of public debt in comparison to GDP by 2017, which will require a permanent fiscal deficit decrease by about 4 pp of GDP – from 6.6% in 2014, to about 2.7% of GDP. Even more importantly, successful implementation of the planned austerity measures and structural reforms should create the necessary preconditions for a more significant decrease of public debt in the long term, leading to a substantial recovery of Serbian public finances. The planned deficit of 2.7% of GDP in 2017 would stop further public debt growth, but this would only eliminate the immediate danger of a debt crisis. For a tangible reduction in public debt (which is necessary as a debt of almost 80% of GDP is very dangerous to countries such as Serbia in case of some new economic crisis in the future) the structural

15 In the observed period (2008-2014), a larger increase in public debt was only observed in Croatia (49% of GDP) and Slovenia (59% of GDP).

Figure 3: Fiscal deficit and public debt in Serbia and CEE countries, 2008-2014



Source: Author's calculations based on the data from IMF WEO database (October 2015 update) and Ministry of Finance of the Republic of Serbia

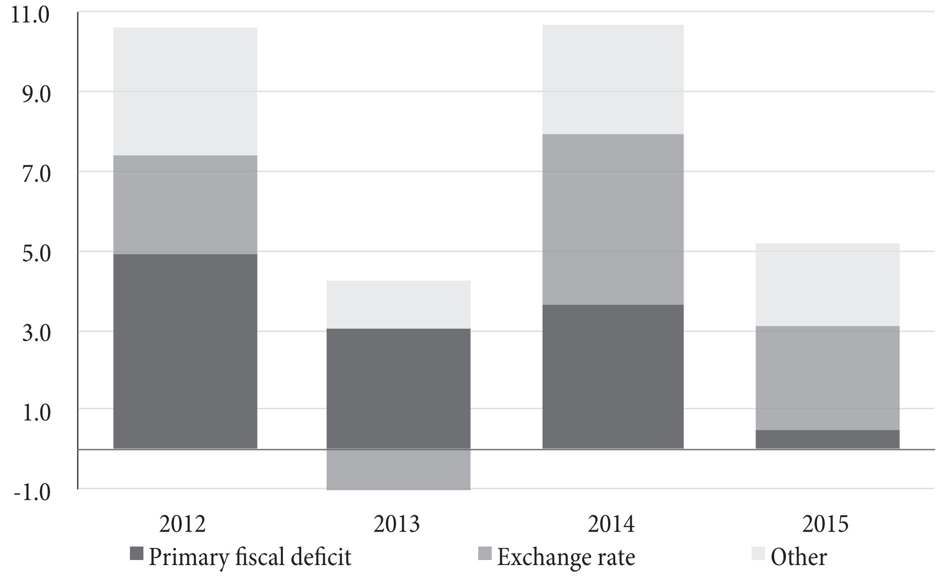
deficit would need to be eliminated completely, or at least brought below 1% of GDP. In this part of paper, we analysed the results achieved in the first year of implementation of this programme, in an attempt to answer the following questions: what is behind the deficit decrease in 2015, how far are we from the target and what are the greatest risks in 2016 and 2017 that could jeopardize the success of this fiscal consolidation attempt?

The first year of fiscal consolidation was relatively successful – the fiscal deficit was reduced to 3.7% of GDP in 2015, which is a strong decrease of about 2.9 pp of GDP in comparison to the previous year. Permanent savings achieved due to the cuts of pensions and salaries in the public sector at the end of the 2014, which are estimated to about 1.4% of GDP, are the most significant contributor to this indisputably good result. Improved tax revenue collection mostly due to the successfully implemented grey economy suppression measures brought additional savings, which we believe to be sustainable, of about 1% of GDP. However, the remaining deficit decrease (of about 0.5% of GDP) is the consequence of several one-offs, the impact of which has most likely been already used up in 2015, so we estimate that the "real" fiscal deficit of Serbia is somewhat larger, amounting to about 4.2% of GDP. This primarily pertains to unusually large payments from state-owned enterprises into the budget, on various grounds, and other sources of one-off increases in non-tax revenue in 2015 – which, by all indicators, will not be repeated to a similar degree in the following years.[16] In addition, the Government has been inefficient in implementing the announced policies (employment rationalisation in general government, privatization and realization of public investments), due to which capital expenditures amounted to less than was planned and the expenses of severance payments were delayed for 2016. We estimate that these one-offs temporarily improved the fiscal result in 2015 by about 1.5% of GDP. On the other hand, at the end of the year, several unplanned liabilities were undertaken (Srbijagas' debt to NIS, liabilities to military pensioners and arrears on agricultural subsidies), which increased the fiscal deficit by over 1% of GDP (RSD 43 billion).

Even though the takeover of these liabilities into the public debt in December 2015 is considered as a one-off expenditure of the budget, it is a fact that such expenses arise each year, again and again, and represent a chronic (structural) problem of Serbian public finance. The problems

16 Similar growth of non-tax revenue based on large transfers to the budget from the still unreformed public and state-owned enterprises would not be economically justifiable either and thus it cannot be a sustainable source of fiscal deficit decrease in medium term.

Figure 4: Contribution of individual factors to the public debt growth in % of GDP, 2012-2015



Source: Author's calculations

of state-owned enterprises and other entities had been "swept under the rug" for years, only to have their debt appear at one point as an unplanned expenditure for the budget. In this manner, in 2013 the unpaid liabilities of the Environment Protection Fund (RSD 5.5 billion) and liabilities of healthcare institutions (RSD 5 billion) were taken over. In 2014, the unplanned expenses practically exploded, reaching RSD 80 billion (over 2% of GDP): the guaranteed debt of public and state-owned enterprises accrued (about RSD 30 billion), costs of the failed banks amounted to about RSD 20 billion, over RSD 9 billion have been paid for the recapitalization of Postanska Stedionica and Dunav Osiguranje, and the unguaranteed debt of JAT of almost RSD 20 billion was also taken over. Such a strong growth of public expenditure to support the unreformed public sector completely annulled any savings achieved in the period 2012-2014 and made all previous attempts at consolidating Serbia's public finances pointless.

The initial fiscal consolidation plan (from the end of 2014) envisaged that the general government deficit should be decreased to about 3.7% of GDP only as late as in 2017, so at first glance it may seem that a three-year fiscal adjustment was successfully completed in a single year. This conclusion, however, is incorrect for several reasons. First of all, we have shown that some temporary factors have contributed to the deficit decrease of 2015, and once these are "cleaned out" we conclude that the deficit was, essentially, somewhat larger. Although significantly decreased, the fiscal deficit in Serbia is still too high and among the highest in Central and Eastern Europe. Even more importantly, a deficit of about 3.7% of GDP does not lead to a halt in public debt growth, as confirmed by the fact that in 2015 as well, the debt increased by quite a substantial 5.2 pp of GDP. A more detailed analysis of the public debt increase structure, however, confirms that an indisputably good result was still achieved in the first year of fiscal consolidation

In Figure 4, we emphasized the contribution of the primary fiscal deficit and the exchange rate movements to the increase of public debt in the period 2012-2015, while the impact of other macro-fiscal factors was shown collectively (real GDP increase, real interest rate, issue of guarantees, etc.). The primary deficit shows the impact of current fiscal policies on public debt increase (as it excludes the expenditures for interest rates, which are the consequence of past deficits) and the achieved fiscal result in 2015 shows, without a doubt, a significant improvement compared to the previous few years. We estimate that the primary deficit contribution to public debt increase in 2015 amounted to about 0.5 % of GDP, compared to the average 3.5 - 4% of GDP in the period 2012-2014. The analysis also shows that one of the greatest risks for sustainability of Serbia's public debt comes from an extremely unfavourable public debt currency structure, where almost 80% of the liabilities are in foreign currencies (primarily euros and dollars). For several years, trends in foreign currency markets have had a strong impact on Serbian debt and the exchange rate risk will remain one of the greater structural challenges for national public finance in the future as well (for as long as the share of dinar liabilities remains relatively low). Among other factors affecting public debt in Serbia, the real interest rate is especially significant, i.e. the enormous budget expenditures for interest payments (reaching about 3.4% of GDP in 2015). This is the main reason why fiscal adjustments are easier to implement at lower level of debt – the greater the debt, the more drastic the austerity measures need to be to stop its growth (as the inevitable increase of expenses for interest rates has to be made up for).[17]

All in all, in 2015 a permanent decrease of the fiscal deficit of about 2.4% of GDP was achieved (of the planned 4% in a three-year period), meaning that additional savings of about 1.5% of GDP need to be made in 2016 and 2017 to achieve the target. Although it may seem that the largest part of the work has been completed in the first year (about 60% of the total adjustments planned), there are several reasons why the remainder of the fiscal consolidation will actually prove to be more challenging and consequently riskier. First of all, the largest budget savings in 2015 were made thanks to the cuts in public sector salaries exceeding RSD 25,000 by 10% and pensions (on average by 5%), which has now been used up. The second important source of permanent deficit decrease in 2015 is now mostly exhausted too: improved tax revenue collection was achieved practically without a Tax Administration reform, mostly thanks to increased control of production and trade of tobacco and oil derivatives. For additional increase in tax revenue collection (for which there certainly is room, considering the estimated scope of grey economy in Serbia of about 30% of GDP), systematic reform of the Tax Administration is necessary – which takes time. In other words, the fiscal consolidation in 2016 and 2017 must be based on savings from structural reforms, instead of individual measures providing large savings very quickly. However, the implementation of important structural reforms in 2015 did not go as planned and thus failed to set good foundations for the continuation of fiscal consolidation. This seriously jeopardizes the sustainability of the fiscal results achieved in 2015 (and partially reduces the success achieved in that year), but also all savings planned in the medium term as well.

The main leverage for permanent deficit decrease in 2016 and 2017 should have been employment rationalisation in general government, but according to all available indicators, the realization of the initial plan (downsizing by 75,000 or about 15% by 2017) and the expected savings will not even come close to the mark. Comparative analyses results show that the target set was too ambitious and difficult to achieve from the start. First of all, no CEE country managed to downsize their general government by 15% in a three-year period since the outbreak of the crisis, nor to reduce the expenditures for employees by 3.3 pp of GDP – which was the plan for Serbia.[18] In addition, if we look at the number of employees per 100 inhabitants, it turns out that Serbia with a little over 7 employees in general government per 100 inhabitants is actually at the CEE average. This unequivocally indicates that the general government in Serbia does not have 75,000 superfluous employees by any account, which provides additional support to the claim that the original plan was unrealistic. Through an independent analysis we came to the estimate that the final reach of employment rationalisation in Serbia most likely amounts to about 30,000-40,000 employees in general government, meaning that the possible savings in the medium term are about a half of what was planned. However, the fact that the targeted layoffs have not even started in 2015 indicates that even this reduced target will not be reached. It seems that even after more than a year of preparations, there is still no firm plan or sufficient

17 In this way, the fiscal consolidation measures that were used up in vein from 2012 to 2014 are not the only expense stemming from the lack of structural reforms in Serbia. The starting position at the beginning of a new three-year program of fiscal adjustment in 2015 was actually much worse – the public debt increased by about 15 pp of GDP in the meantime, and expenditures for interests almost doubled.

18 According to Eurostat data, the largest decreases in expenditures for employees were achieved by Lithuania and Romania (by 3 pp of GDP), Latvia (2.5% of GDP), Portugal (2.2% of GDP) and Estonia (1.5% of GDP) – but in a period of five years. In addition, it is important to note that in certain countries, a large part of this decrease in expenditures for employees can be explained by a sharp salary cut (even up to 30%) rather than by downsizing.

decisiveness to implement these measures, or to reform the largest public systems (education, healthcare, defence, etc.) that should follow through with this plan. This is substantiated by the fact that the newest deadlines for the final beginning of targeted layoffs have been moved, yet again (although it was announced that the number of employees in January 2016 will be decreased by 9,000 it did not take place).

The remaining planned austerity measures in 2016 and 2017 do not seem too credible at the moment either. The second most important fiscal consolidation measure in these two years should be the salary freeze in the public sector and the pension freeze, but this was partially given up on at the end of 2015. Even though the increase was modest, with the expectedly low inflation in 2016, practically none of the savings originally planned from the freeze will actually be made in this year – even if there are no new raises. However, the pressures on Government to repeat this to a certain extent in this year or in 2017 can only be larger. Another obvious risk is the planned decrease of agricultural subsidies, being that a similar plan in 2015 failed completely. Instead of a RSD 6 billion decrease, the actual liabilities for agricultural subsidies were RSD 10 billion higher than planned for in the budget – which, at the end of the year, was included into Serbian public debt. In order to achieve these savings, it has been envisaged that incentives by hectare in 2016 should be about a third of the usual incentives from the previous years. We estimate that such a radical turn in agricultural subsidy policies will very likely be severely tested in practice (due to possible pressures from agricultural producers on the Government), which is why it could easily transpire that the budgeted funds do not suffice.

Despite certain improvements, there has been no tangible progress in 2015 with regards to the reform of public and state-owned enterprises, so there is still danger that their business failures may lead to new expenditures for the budget. What's more, it is now fairly evident that Petrohemija's debt to NIS and the guaranteed debt of the RTB Bor will accrue in 2016 (a total of EUR 100 m, or 0.3% of GDP). The greatest success was that certain organisational changes had been implemented in EPS and Zeleznice (which were divided into four companies). However, the main problems of state-owned enterprises and the sources of their poor business performances – redundant employees, prices below market level, low debt collection, technical losses and many others – have not been resolved, not even close. A part of the improvements in 2015 stems from the external environment and is the consequence of the currently very low oil prices on the world market. This was reflected in Srbijagas' level of debt collection for the delivered gas, but not as a result of successful restructuring of its debtors (the petrochemical complex, Zelezara Smederevo and others), which is why this success is only temporary. A positive change in 2015 is the resolution of the status of companies undergoing privatization which has finally begun, although this process is unfolding much slower than planned (if we observe the number of employees still employed in these companies, about a third of the problems have been resolved). Even more importantly, there are still no permanent solutions for the most problematic companies (RTB Bor, Resavica, Petrohemija, Galenika, Simpo and others from the group of strategically important companies), which represent the highest potential fiscal risk. Their final status (privatization or bankruptcy) should be known by May 31, 2016 (when the state's protection of these companies from the creditors' claims will cease), but there are already indications of temporary solutions being planned for a large number of these companies, which are not sustainable in the long term. As an example, the deadline for the resolution of the status of RTB Bor will only be delayed, by all indicators available. There is a group of (unsuccessful) companies which are planned to be merged with larger state entities, so that their business operations would still essentially depend on the state (such as linking Resavica and EPS or merger of certain companies into the military industry), which can hardly constitute a sustainable solution.

Fiscal plans for 2016 and 2017 promise permanent savings of about 1.5% of GDP "on paper" and a deficit decrease to 2.7% of GDP, but our analyses show that there is a substantial risk that at least a half of the planned structural adjustments will not take place. Due to premature relaxation and insufficiently prepared measures, the fiscal deficit in Serbia could very easily stop at a permanent level of 3.5% of GDP (with small fluctuations from time to time)

– which is insufficient to halt the public debt growth and for successful fiscal consolidation. On the contrary, the public debt would continue to increase over 80% of GDP, with further increase in interest payments, which would mean that all the sacrifices from 2015 would have been in vain (again). Moreover, even if all the planned austerity measures in 2016 and 2017 were to be implemented consistently (which does not seem likely at the moment), that too could prove to be insufficient if a full control of business operations and the necessary reform of public and state-owned enterprises are not implemented. On the other hand, a more efficient suppression of grey economy could somewhat mitigate the existing fiscal risks, but not make up for the firm fiscal consolidation measures. Relevant analyses show that, in medium term, it is possible to achieve an increase in tax revenue collection in Serbia by about 0.8-1.1% of GDP, with systemic measures for the suppression of grey economy. In the first place, this means a thorough reform of the Tax Administration; the main obstacles for a more efficient work of this institution have already been recognized – the current organisational structure, which is not rational, needs to be improved, human capacities strengthened and a unified information system introduced.

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