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SERBIA: FISCAL CONSOLIDATION – PROGRAM DESIGN AND POLITICAL ECONOMY ISSUES

Srbija: Fiskalna konsolidacija – definisanje programa i polit-ekonomska pitanja

Abstract

Fiscal consolidation in Serbia was built on broad-based expenditure cuts, better revenue performance, and related structural reforms and pro-growth policies. In 2015 the actual fiscal performance exceeded the original and revised deficit targets set in the IMF program. The final outcome was a deficit of 3.7 percent of GDP, a huge 2.9 percent improvement over 2014. The result contains a 2.5 percentage points of structural fiscal adjustment with 1.5 percentage points in permanent expenditure cuts and 1.0 percentage point in structural revenue improvements. This increases front loading and allows more fiscal space for the implementation of pending structural reforms.

The program had a beneficial impact on economic growth which turned out positive at 0.8 percent, 1.3 percentage points above IMF and IFI projections. 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 the most difficult circumstances.

The political economy issues of fiscal consolidation and structural reforms gain increasing importance in the second year of the program, two months before the early parliamentary elections. Fresh thinking is needed to demonstrate that the completion of difficult reforms is a win-win for all, and almost 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 smanjenju rashoda, povećanju budžetskih prihoda i povezanim strukturnim reformama i politikama koje podržavaju ekonomski rast. Tokom 2015. godine ostvareni fiskalni rezultati prevazišli su originalne i revidirane ciljeve postavljene u MMF programu. Rezultirajući deficit od 3,7 posto BDP predstavlja veliko poboljšanje od 2,9 procentnih poena u odnosu na 2014. Ovaj rezultat sadrži strukturno poboljšanje deficita od 2,5 procentnih poena, od čega se 1,5 procentni poen odnosi na trajno smanjenje rashoda, a 1,0 procentni poen na strukturno povećanje prihoda. Ovim se povećava ostvarenje u prvoj godini i stvara dodatni prostor za realizaciju preostalih strukturnih reformi.

Program je dobro delovao na ekonomski rast koji je ostvaren sa +0,8 posto, 1,3 procentnih poena iznad projekcija MMF i drugih MFO. Sa ovakvim performansama Srbija može da postane primer tzv. „ekspanzivne štednje" koji pokazuje 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 sa naporima za povećanje prihoda može da ima 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 stimulus, javni dug, strukturne reforme, štednja, restriktivna fiskalna politika, ekspanzivna fiskalna politika, ekonomski rast, mere za smanjivanje rashoda, mere za povećanje prihoda*

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Introduction – Prelude to fiscal consolidation: Creating political space for reform

The need for fiscal consolidation in Serbia became quite apparent in late 2011 as the public debt exceeded the 45 percent debt-to-GDP fiscal rule set in the Budget System Law. The debt level was projected to continue growing and reach 50 percent by the end of 2012. After accounting for local government debt, additional downside risks linked to state guarantees issued to public enterprises, and likely dinar depreciation, the Fiscal Council warned that an augmented debt-to-GDP ratio could easily be 5 percentage points higher (i.e. 55 percent at the end of 2012) and continue growing in the medium term. This trend could not be reversed in the medium run even under the most optimistic growth and fiscal projections: assuming 3 and 4 percent annual GDP in 2013 and 2014 respectively, and budget deficits fully aligned with fiscal rules (3.7 and 2.9 percent), the debt would continue to increase both in absolute Euro terms and as a share of GDP. After accounting for the effects of further dinar depreciation, Serbia would be set on a path to approach the Maastricht 60 percent criterion as early as at the end of 2013. And that actually happened: on December 31, 2013 debt represented 59.6 percent of GDP.

One-off factors and external shocks associated with the global financial crisis exacerbated the worsening debt situation but did not cause the problem. The real cause was the inherent structural disbalance between longer-run expenditure commitments (especially on pensions and public sector wages) and eroding revenue capacity adversely affected by the post-crisis recession and faltering performance of public sector companies.

Timely calls for an immediate fiscal consolidation program were not taken seriously. A precautionary IMF stand-by arrangement signed in late September 2011 did not have much ownership in the government. The completion of the first review was postponed as the draft 2012 budget deviated from the agreed fiscal program in the planned level of public debt (including government guarantees) and domestically-financed projects. IMF projected that true fiscal deficit, including the so called below the line items, would significantly exceed targeted levels and jeopardize debt sustainability in the absence of an effective and credible medium-term fiscal consolidation.

An explicitly stated concern that "fiscal consolidation is therefore an urgent priority" and an announcement that, despite a fiscal and debt crisis in the making, "IMF mission will return to Belgrade (only) in mid-2012 to discuss with the new government the steps needed to resume program reviews" effectively meant an early cancelation of the program in the absence of government ownership and commitment.

Although this irrevocably put Serbia on a non-sustainable medium run debt path, the news did not attract much (any) public attention captured by the ensuing political cycle centered on the parliamentary and presidential elections expected in May 2012. Actually, this and other burning macroeconomic and structural issues were put on a back-burner while the new government had to use all its efforts to resolve the backlog of pending issues and firmly put Serbia back on EU accession track in January 2014.

IMF repeated efforts (in September and November 2012, and March, July, October 2013) to resume fiscal consolidation efforts through a new program did not produce sufficient response in the government. As fiscal deficits persisted and debt levels continued to increase (EUR 20.5 billion or 60.9 percent of GDP at the end of first quarter 2014), fiscal consolidation and economic reforms became the leading issues in the parliamentary elections held on March 16, 2014. Alexander Vucic and Serbian Progressive Party received a strong political mandate to supplement the EU accession strategy with a sound fiscal consolidation and economic reform program.

Due to centennial floods in May 2014, only weeks after the government was appointed on April 27, 2014, and changes at the helm of the Ministry of Finance, the work on the design of the long-awaited program could not start till August 2014. Somewhat delayed start was fully compensated by an accelerated preparation pace. By mid-September the Prime Minister announced the government's 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 stateowned enterprises in distress, improved efficiency of public utility/infrastructure companies, and public sector rightsizing. 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 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 restructuring underpinning structural reforms.

Today, 17 months after the initial implementation of public sector wage cuts and reductions of some pensions, and 14 months after the implementation of the full fiscal consolidation and economic reform program we have enough time distance and tangible results to evaluate. We will look both at 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 key principles and approaches leading the design of the 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 2016-2017 and beyond. Section four discusses the political economy issues of fiscal consolidation and structural reforms looming large two months before the early parliamentary elections expected to be called for end 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

Fiscal consolidation defined: Approaches to fiscal consolidation

OECD Sources and Methods define fiscal consolidation as a policy aimed at reducing government deficits and debt accumulation. We prefer a more flexible definition in which fiscal consolidation is defined as a policy aimed at achieving sustainable levels of fiscal deficit and public debt.

The austerity approach to fiscal consolidation says that lower fiscal deficits can only be achieved through (preferably) lower expenditures and (possibly) higher revenues. Some authors (such as *Alesina* [1], [4]) even claim that austerity measures can in the end be expansionary as the positive longer-run effects outpace the short run contractionary effects, although this is not easily confirmed by empirical evidence [37]. The key mechanism through which public expenditure cuts lead to lower deficits is based on private sector investment response and the presence of complementing pro-growth measures.

Keynesians (see *Krugman* [41] and *Perotti* [44]) claim exactly the opposite: that fiscal deficits are best reduced through fiscal stimulus which combines higher expenditures (government spending) and lower taxes (revenues). Under certain assumptions (output gap, large multipliers, short-run) higher government spending can boost aggregate demand. In combination with lower tax rates this can lead to higher level of economic activity and GDP growth, which ultimately generates higher tax revenues, lower fiscal deficits, and lower public debt.

Keynesians also say that, assuming large multipliers, expenditure cuts would reduce aggregate demand and in combination with higher taxes push the economy into recession or even crises.

In real life situations these scholarly differences are less important. What really matters are the output responses to fiscal measures [5], [6] and private sector investment responses to government spending cuts and tax policy changes. It is important to note that the level of multipliers does not affect the timing and the speed of fiscal consolidation measures. But the change in the level of multipliers does [11].

The scope 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 design and content of Serbia fiscal consolidation program ...

From thematic point of view, Serbia fiscal consolidation is embedded in a wider economic reform program which covers three related thematic areas:

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 public 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 and additional fuel excise taxes), 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. 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 IFIs, 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 improved 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.

The initial results of the program

Fiscal balance developments

In this section we will highlight selectively some of the main results of the program achieved thus far with a clear objective to address the issues of program design, possible choices and outcomes.

Macro-monetary performance has been solid throughout this period: average inflation for 2015 was at 1.9 percent, down from 2.9 percent in 2014 and well below the 2.5% lower bound of the 4% inflation target. With few minor exceptions attributable largely to speculative behavior of domestic banks, the dinar-euro exchange rate has been very stable. In real terms the EUR/RSD period average exchange rate depreciated by 1 percent (compared to 1.2 percent in 2014).

Fiscal performance recorded a major improvement exceeding the original and revised deficit targets set in the IMF supported three-year precautionary program. In 2015, planned fiscal deficit of the general government was set at RSD 232 billion or 5.9 percent of GDP. Based on very good performance during the first six months, target deficit was revised down to RSD 160 billion (4.0 percent of GDP), while the actual outcome for the year was still below (RSD 149.1 billion or 3.7 percent of GDP). This is 2.9 percentage points below the deficit recorded in 2014, indicating a huge improvement both on the revenue and expenditure side (see Table 1 for details).

Furthermore, this result contains a permanent structural improvement of 2.5 percent or 62.5 percent out of the overall 4.0 percent total fiscal adjustment envisaged under the IMF program. Compared to the initial plan (50:25:25), this implies considerably stronger front loading (62.5:17.5:20.0) which allows more fiscal space for the implementation of difficult structural reforms in the next two years.

Table 1: Serbia – Improvement in fiscal deficit explained, in percent of GDP

	2015
TOTAL ADJUSTMENT IN THE FISCAL BALANCE	**2.9**
Total adjustment on the revenue side	**1.9**
Of which: changes with permanent structural effects	
Better revenue performance (VAT, excises, contributions)	1.0
Of which: changes with one-off effects	
Extra dividends and profits of public companies	0.8
Increases in other non-tax revenues	0.1
Total adjustment on the expenditure side*)	**1.0**
Of which: changes with permanent structural effects	
Pension reductions	0.5
Public sector wages reductions	1.0
Other expenditure cuts with effects on fiscal balance	
Interest payments	-0.4
*Subsidies**)*	0.4
Capital expenditures	-0.4
Assumed debts (late military pensions, Serbia-gas debts to NIS, agricultural subsidies, etc.) – change over 2014***)	-0.1

*) Positive number indicates reduction in expenditures i.e. positive fiscal impact.
**) Includes reductions/changes in all subsidies
***) Includes elimination of recapitalization of banks, and insurance companies.

Source: Ministry of Finance

The fiscal adjustment was spread evenly throughout the year as indicated in Figure 1. The improvements have been recorded in every single month. The December spike in expenditures and deficit remained albeit at a somewhat lower level (RSD 83.7 billion in 2015 versus RSD 88.4 billion in 2014). In both years, 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; (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 Figure 1, the first two factors amounted to RSD 14 billion for relocation of current expenditures and additional RSD 4 billion for capital. In 2015 the assumption of debts amounted to RSD 43 billion, more than half the December deficit and over 1 percent of GDP. In 2014 the assumption of old debts amounted to RSD 40.9 billion. Although no payments were made in 2014 or 2015 against the assumed debts, they are recorded in both the increased public debt and in the cash-based fiscal deficit. This departure from the cash-based fiscal accounting rules was introduced in 2012 at the request of the IMF to curb the scope for further public debt increases channeled substantially 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.

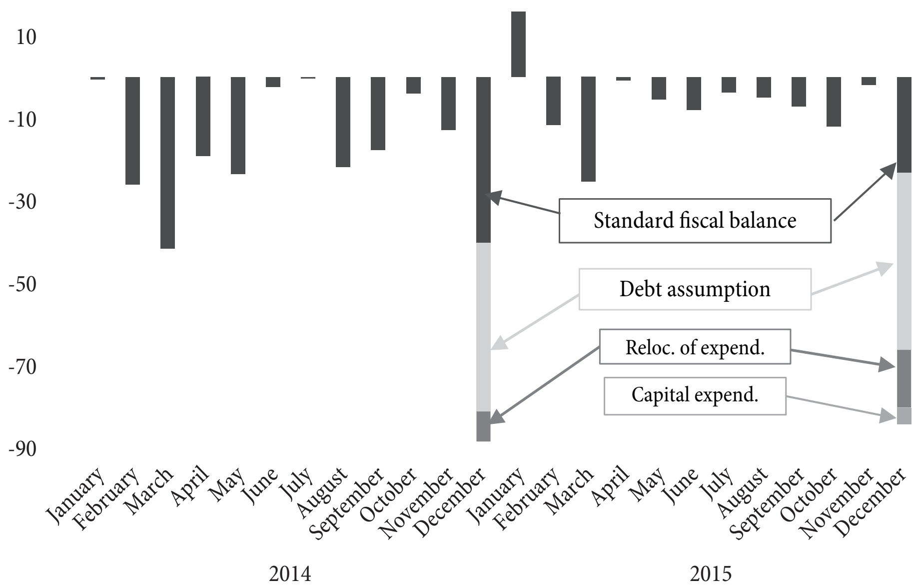
In short, fiscal consolidation was built both on broad-based expenditure cuts and better revenue performance. Out of 2.9 percent fiscal balance improvement over 2014, predominant part (2.5 percentage points or 86 percent of change) stems from permanent, structural improvements. In that, permanent expenditure cuts contribute 3/5 (1.5 percentage point) and structural revenue improvements 2/5 (1.0 percentage point).

Economic growth: How big was the recessionary impact of the program?

One of the major concerns of governments embarking on fiscal a consolidation program based on expenditure cuts was the potential recessionary impact. These concerns were exacerbated in the presence of global recessionary pressures, external shocks and multiple constraints to growth.

In Serbia, additional concerns regarding growth impact of a possible fiscal consolidation program came from the fact that brief economic expansion in 2013

Figure 1: Serbia – December seasonality explained, monthly fiscal balance 2014-2015



Source: Ministry of Finance

came to a large extent 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.

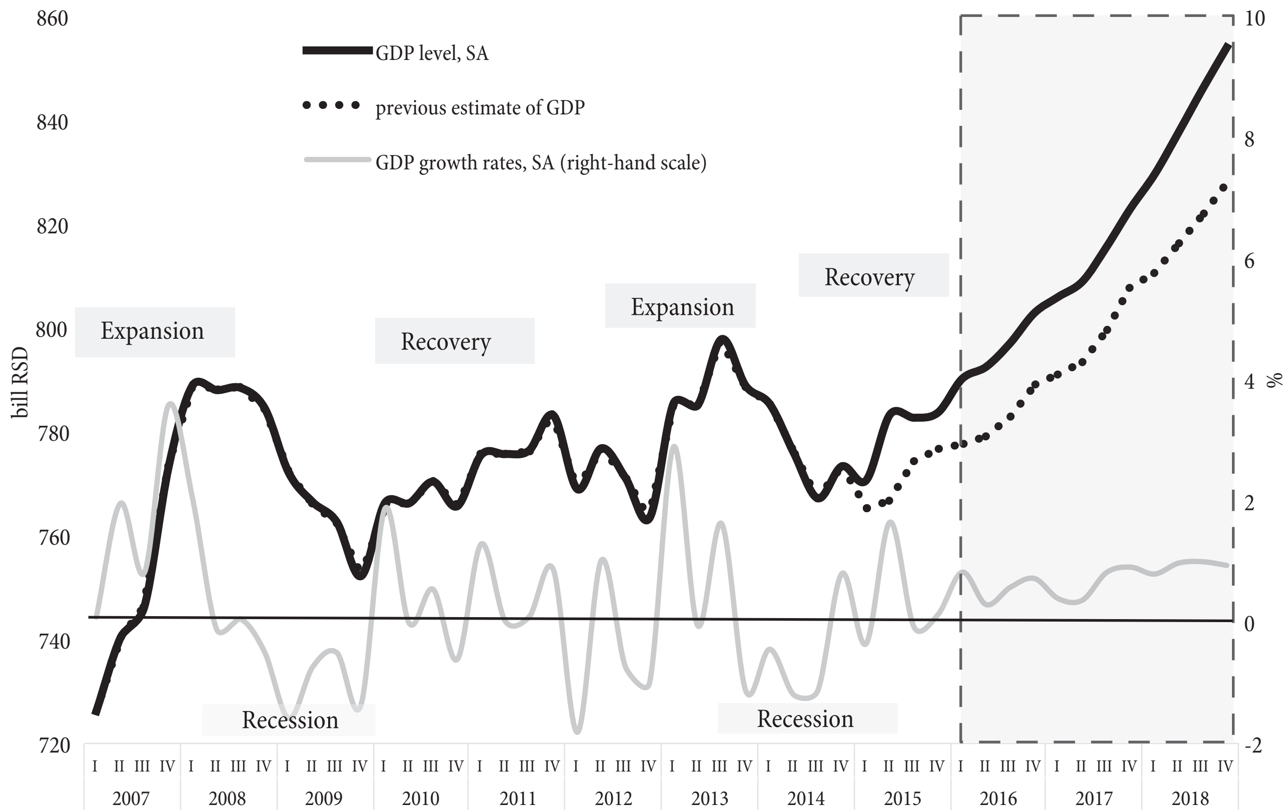
The negative impact of May 2014 floods on GDP growth demonstrated how fragile the un-restructured economy was and actually reversed the sentiments in favor of tough reforms that would ultimately create a more robust economy. It became apparent that the call for fiscal consolidation and economic reforms 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.

The turning point came in the third quarter and the economy started recovering in late 2014-early 2015 (see Figure 2). Despite conservative projections from the IMF and other IFIs that growth would 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 growth recovery will continue throughout the 2016-2018 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 by *Alesina et al.* [4], when fiscal consolidation programs are designed in line with sound principles summarized by *Blanchard* & *Leigh* [11], [12], and synchronized with key structural reforms and pro-growth policies, they can generate growth. Carefully selected expenditure cuts combined with revenue collection efforts aimed at shadow economy described in Table 1 show that initial fiscal adjustment does not have to be recessionary even under the most difficult circumstances. An upward

Figure 2: Serbia GDP level and growth rates, quarterly data



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

1.3 percent growth rate revision captures not only the "conservative buffer error" but also indicates that there are positive behavioral changes and responses to persistent and comprehensive reform effort.

Public debt and program consistency

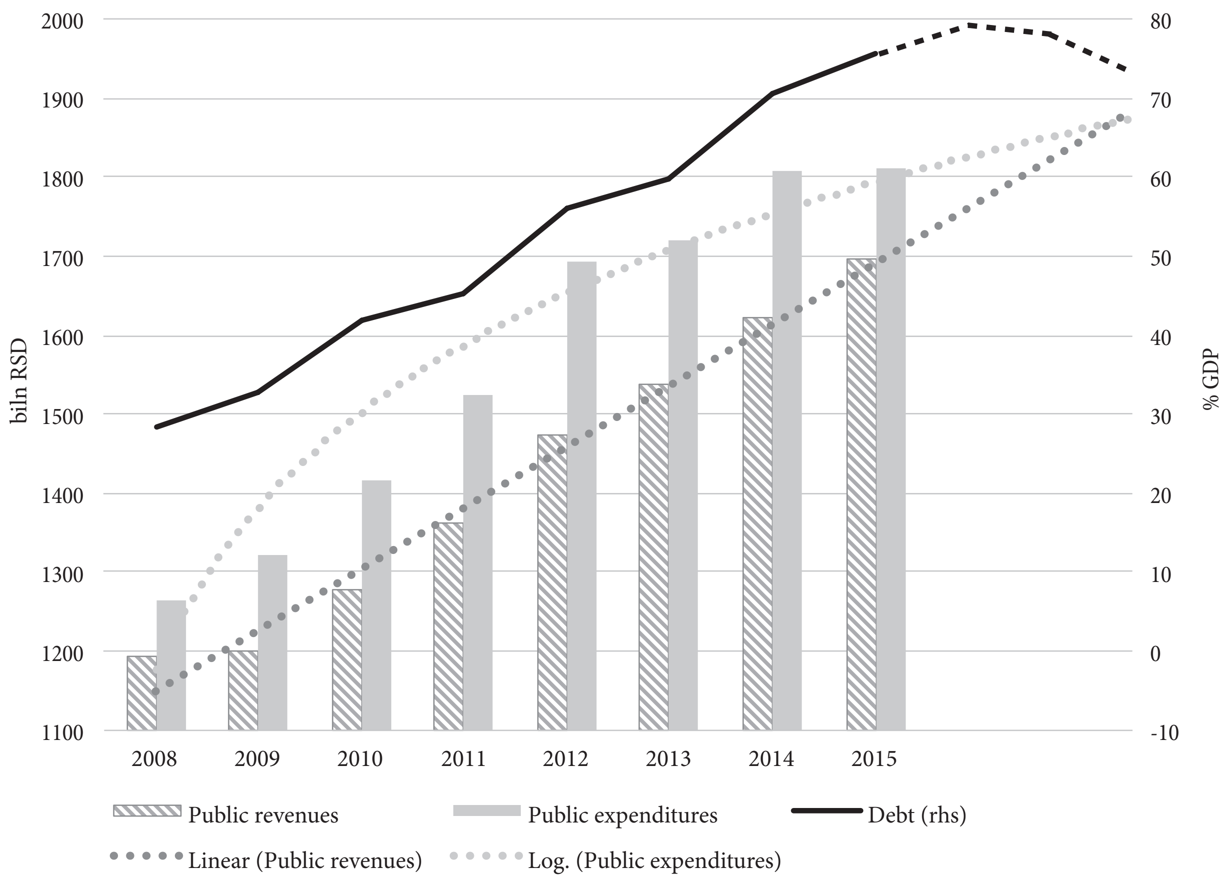
Stopping the growth of fiscal deficit and the buildup of public debt are the main reasons for embarking on a fiscal consolidation program. Achieving the sustainable levels of fiscal deficit and public debt are the desired outcomes of a well-designed fiscal consolidation program. Figure 3 summarizes the 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 deficit already achieved in 2015 (3.7 percent compared to 4.1 percent estimate from November 2015) could be the basis for a more ambitious convergence to a balanced budget by 2018 depicted in Figure 3.

Select political economy issues of the program

The political economy issues of fiscal consolidation and structural reforms are increasing in importance two months before the early parliamentary elections expected to be called for end April 2016. Complex political issues notwithstanding, Prime Minister Vucic will be seeking confirmation for the bald fiscal consolidation and economic reform program discussed in this paper. The initial support provided in an overwhelming victory in March 2014, yielding Serbian Progressive Party more than 50 percent of the seats in Parliament, will be again tested. This time, Mr. Vucic will be able to show clear results achieved thus far, credible promises for the coming four years, as well as demonstrate a firm rationale for continued efforts needed to meet future challenges and clear multiple hurdles on the road of EU integration internationally and successful fiscal consolidation at home.

This would be a demanding task even with full by-partisan political support as reform fatigue settles in

Figure 3: Serbia – Public revenues, public expenditures, and debt-to-GDP ratios



Source: Ministry of Finance, Public Debt Department, Ministry of Finance and vulnerable groups are potentially a captive audience for manipulation based on unfounded promises. Greece is a clear example. The task becomes considerably more complicated in the presence of ill-intended, misinformed assaults on the rational content of the program and refusal to recognize the most obvious measurable results discussed in this paper. This section will briefly discuss some of the most obvious political economy issues that motivate this behavior. All recent public opinion polls show that these interest groups are not likely to upset the outcome of the elections, but they may well be strong enough to delay or stall the future progress in program implementation.

The cost of delayed fiscal consolidation and reform program

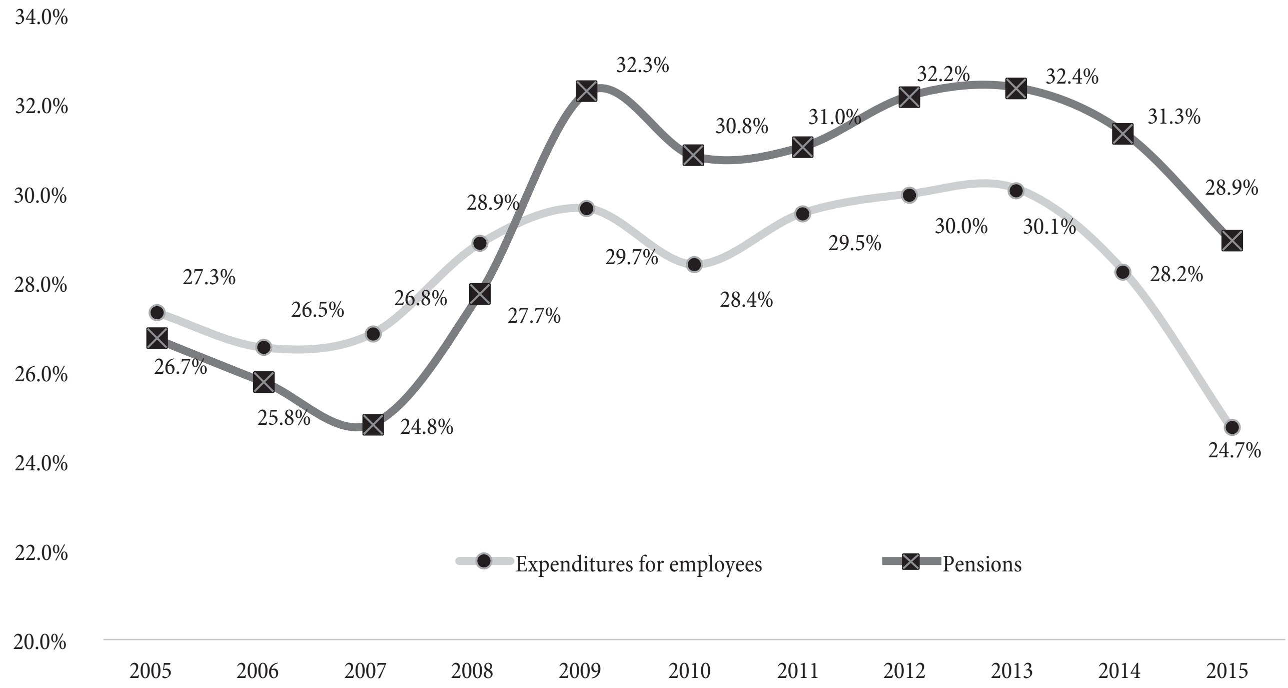
As already discussed in the introductory section, fiscal consolidation had been postponed, resisted and ultimately rejected in 2011 despite growing fiscal deficits and public debt. Much of the delay was inspired or driven by special interest groups with significant political influence. The discussion of old and the emergence of new interest groups in Serbia, their behavioral patterns, political alliances, and full political economy considerations goes beyond the scope of this paper. We will limit our discussion to few examples that clearly indicate deep fiscal consequences political economy issues have had in Serbia in the past ten years.

Two developments are particularly interesting.

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, 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

Figure 4: Serbia – Share of public sector wages and pensions in revenues



Source: Ministry of Finance

line, exceeds fiscal deficit – dotted 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.

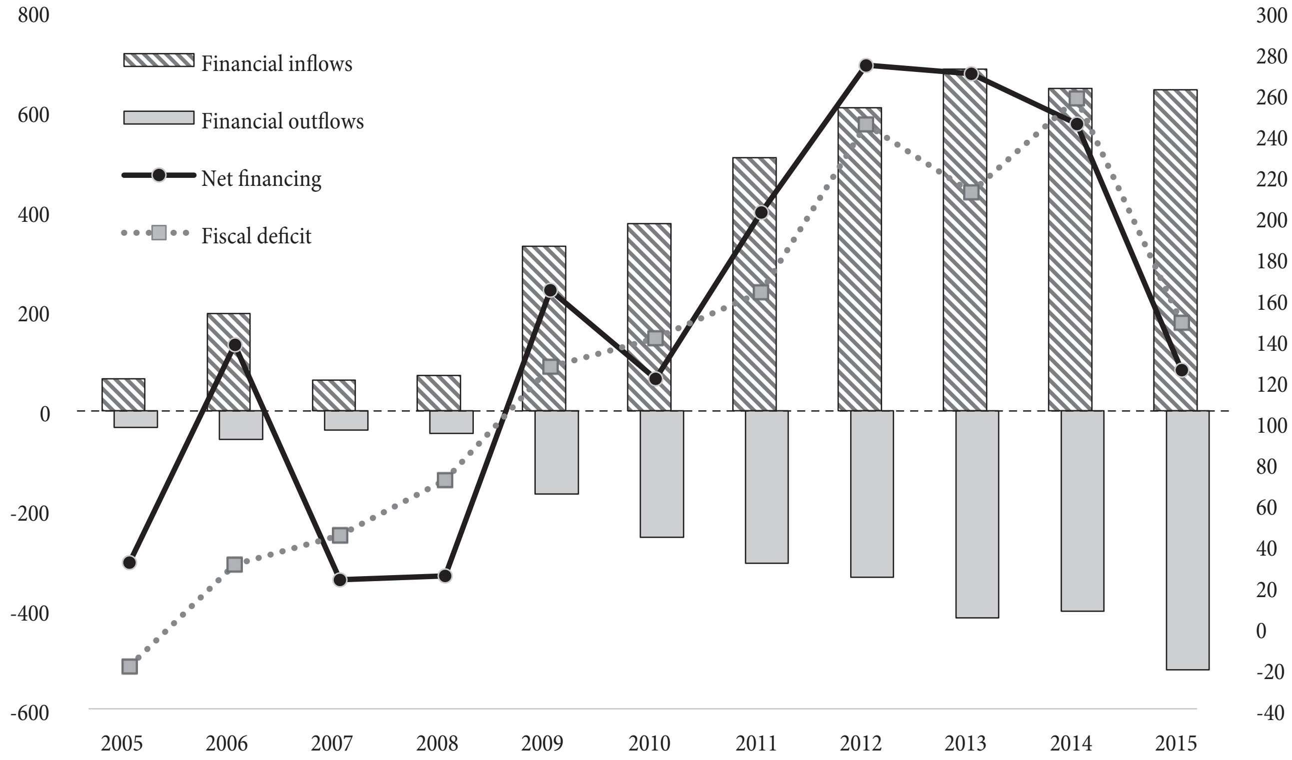
Present political economy issues can slow down structural reforms

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 focused on creating new jobs on a net basis rather than protecting old jobs 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 almost everybody loses if reforms are stalled or abandoned.

Figure 5: Serbia – Financial flows, net financing, and fiscal deficit, in billion RSD



Source: Ministry of Finance

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 built on broad-based expenditure cuts, better revenue performance, and related structural reforms and pro-growth policies. In the first year of implementation the actual fiscal performance exceeded the original and revised deficit targets set in the IMF supported three-year precautionary program. The final outcome was a deficit of 3.7 percent of GDP, a huge 2.9 percent improvement over 6.6 percent deficit recorded in 2014.

This result contains an impressive structural deficit improvement of 2.5 percentage points or 62.5 percent out of the overall 4.0 percent total structural fiscal adjustment envisaged under the IMF program. The improvement was composed of 1.5 percentage points in permanent expenditure cuts and 1.0 percentage point in structural revenue improvements. This result also increases front-loading of the program from (50:25:25) the initial plan to (62.5:17.5:20.0) which allows more fiscal space for the implementation of difficult structural reforms in the next two years.

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. Despite conservative projections of the IMF and other IFIs that growth would remain negative throughout 2015 (between -0.5 and -1.0 percent) the actual there was a positive 0.8 percent growth for the entire year. It appears likely that growth recovery will continue throughout the 2016-2018 period yielding a substantial difference in GDP and all related economic and welfare indicators.

With this 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* & *Leigh* [11], [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 the 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 two months before the early parliamentary elections in which Premier Vucic seeks confirmation for the bald fiscal consolidation and economic reform program discussed in this paper. This time, he will be able to show clear results achieved thus far, convey credible promises for the coming four years and demonstrate a firm rationale for continued efforts needed to meet future challenges, clear multiple hurdles on the road of EU integration and successfully complete fiscal consolidation. This would be a demanding task in the absence of by-partisan political support as reform fatigue settles in and vulnerable groups are potentially a captive audience for manipulation.

The key implementation risks are now on advancing structural reforms by 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 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 almost 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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