Republic of Serbia

**Fiscal Council**

# EFFECTS OF THE HEALTHCARE CRISIS ON FISCAL AND ECONOMIC TRENDS IN 2020 AND RECOMMENDATIONS FOR FISCAL POLICY IN 2021

## Summary

**Following the implementation of the economy rescue package, new challenges come in the form of stopping further rise in public debt and correcting the enlarged budget imbalances.** The healthcare crisis continues, economy is still in trouble and the government no longer has sufficient resources available for a strong intervention - all the more so since it has already taken on an unreasonable debt and spent over 600 m Euros on the payment of 100 Euros to each citizen of legal age. In these circumstances, we currently expect a GDP drop of about 3% in 2020. Economic consequences of the healthcare crisis are not, however, limited to economic activity only: all of the most important fiscal indicators have been completely thrown off balance. General government deficit in 2020 will be at a record-breaking 7% of GDP, public debt will reach a little over 60% of GDP at the end of the year and internal budget imbalances are also rapidly widening. The latter is the consequence, first and foremost, of the immoderately large increase of salaries in the public sector of about 10% at the beginning of 2020 (this increase of salaries would have been excessive even if the economy had achieved the planned 4% growth). It is therefore necessary to adjust the fiscal policy to the new circumstances and to provide, within this altered framework, the best possible support to the economy. Specifically, this means: 1) reduce deficit in 2021 to about 2% of GDP to prevent the further rise in public debt and to restore fiscal stability; 2) increase in government investments in infrastructure and 3) control of the growth of pensions and salaries in the public sector in 2021 (it would be justified to freeze the salaries entirely). At that, this crisis has given us additional reason to analyse some of the previously observed fiscal policy mistakes - insufficient healthcare investments over a long period of time - that also need to be corrected in the future.

**Economic activity will show a drop in 2020, which we currently estimate at about 3%.** All forecasts in this report (both macroeconomic and fiscal) have a large margin of uncertainty for objective reasons. They should not, therefore, be interpreted as unconditional and entirely precise, but rather as the currently most probable outcome of the expected changes in economic indicators. With the currently available data, we estimate that the GDP drop in 2020 could be about 3%. Namely, after a relatively high GDP growth in the first quarter, when the crisis effects on economy had not yet materialized, we expect that the GDP will drop by about 5% for the rest of the year (a somewhat larger drop during the state of emergency and then a stabilization of the fall in the second half of the year). In total, this would result in an overall GDP drop of about 3% in 2020. This forecast is consistent with the expectations of the relevant international institutions as well. If, however, there is another rigorous limitation of movement for the population and a prohibition of operation in certain industries, the economic activity will be even lower than the previous forecast - the GDP drop in 2020 would, in that case, be larger than 3% and could amount to about 5%.

**Serbia's GDP drop will be smaller than that of most European countries due to the structure of the economy, not due to better economic policy.** All international comparisons show that Serbia is expecting a smaller decline in economic activity than the majority of European countries. The reason for a smaller GDP drop in Serbia (as in some other less developed European countries) lies in the fact that relatively large share of the economy produces basic, essential goods, and the demand for such goods has not declined significantly during this crisis (food, hygiene products etc). Thus, the share of agriculture in Serbian economy is 7.5%, more than twice its share in the economies of Central and Eastern European countries that are members of the European union (CEE11), where it is 3.3% on average - and as much as five times higher than in the developed Western European countries (1.5%). Food industry's share in the economy shows a similar pattern: in Serbia, this industry makes up 4.5% of the economy, in CEE11 2.7% and in the developed Western Europe - 1.9% of the GDP. Unlike Serbia, economies in the developed European countries rely more on the production of goods and services of a higher value-added (automotive industry, machines and equipment, appliances, tourism etc.) for which the demand has dropped significantly during this crisis. Hence, the more developed countries are expecting a significantly larger production drop in 2020 than Serbia.

**We estimate that the economic drop in 2020 will lead to the decrease in employment by 30-50 thousand people.** Forecasting employment trends during the crisis is particularly challenging and uncertain. However, there are numerous unfounded statements already being made in public - from the forecasts of the unions that, without a new support package, several hundred thousand people will lose their jobs, to the assessments of the Ministry of Labour that the number of employed persons will keep increasing. A comparative analysis shows that European countries are losing, on average, about 0.4% of jobs with every percent of GDP drop. With such an employment elasticity relative to production, the expected GDP drop in Serbia of about 3% in 2020 would lead to a moderate decrease in employment of about 1 to 1.5%. This means that during the crisis, 30-50,000 of the employed could lose their jobs. The employment decrease trend is still not visible in the available data, as the data on informal employment (where this decrease has probably already started) are published with a delay, while a major state support package for the economy is being paid out in the formal sector, in an effort to preserve jobs. Once this support lapses in the second half of the year, an employment drop in the formal sector is almost certain. When it comes to salaries, data from April are already hinting at a deceleration in the growth of salaries in the private sector, while the salaries in the public sector are maintaining their high growth that was previously defined in the Supplementary budget in 2019 (with an additional salary increase for healthcare workers in April 2020). These trends increase the already excessive wage gap between employees in public sector and employees in private sector (which, in April, reached 25% in favour of the public sector). Frequent forecasts from state officials that the average salary in Serbia at the end of 2025 shall reach 900 Euros were not credible even before the crisis, and now they are sending the wrong signal to the public that the crisis will have no detrimental effect on the salary (and employment) trends.

**We estimate the fiscal deficit in 2020 to about 7% of GDP (over 3 bn Euros) if there is no additional support package for the economy.** Consolidated government deficit of about 7%

of GDP (which we expect to see in 2020) is practically identical to the one planned in the Supplementary budget in April 2020. Still, some changes have occurred compared to the Supplementary budget. On one hand, not all envisaged funds from the anti-crisis package will be used, primarily because 30% of firms have not used the option to delay the payment of taxes and salary contributions and income tax. In addition, there is an improvement in the collection of the excise tax, as the consumption of the products that are subject to this tax has turned out to be rather stable during the crisis so far. On the other hand, it is now certain that the healthcare crisis will last longer than expected in April - which will have a stronger negative effect on the public finance than planned. This is still not clearly seen from the data, as the generous budget support to the economy has created an illusion that the economic trends and public revenue are better off than they truly are. In the months following the payment of the support package, it will be easier to see how many companies will face severe challenges in conducting business, how many jobs will be lost, what will be the salary trends in the private sector and other major bases for the collection of public revenue. Hence, we currently estimate that, without changes to the current policies, the budget deficit will most likely be similar to the one planned in the Supplementary budget, even though a good part of the planned state support package has not been used. In case of a change in economic policy, the deficit could easily exceed the plan as this change would probably mean an additional (but certainly smaller) economy support package and/or payment of financial aid to certain enterprises in which the government is a shareholder (e.g. Air Serbia).

**Any new support package for private sector would have to be significantly smaller than the first one, but also selective and temporary.** An extremely high deficit and consequentially rapid increase of public debt in 2020 are the reasons why any additional state aid to the economy (which is increasingly being mentioned by government officials) cannot be even remotely as large as the first anti-crisis package. This shows, from another angle, how big economic policy mistake was to pay out 100 euros to all citizens of legal age, which was, at the same time, the largest objection of the Fiscal Council to the Government's anti-crisis program. If the government now had those funds of over 600 m Euros at its disposal, the second anti-crisis package could have been much more generous and of far greater impact on the decrease of unemployment and mitigation of the recession. Limited government resources, however, are not the only reason why any second government support package would have to be far more selective than the first one. Namely, when the first support package was being implemented, urgency in implementation had a priority over the precise selection of beneficiaries, which is not the case now - all the more since enough time has passed to get a better view of the impact of the crisis on the individual enterprises. This specifically means that no support should be given to those enterprises that have not suffered significant losses during the crisis, or to those that have no chance of recovery even with a new state aid package. It is of utmost importance, therefore, to have reliable analyses that would show where such additional assistance from the government is necessary, but also, where it fits the purpose - as it is impossible to keep providing state aid to those enterprises with no clear perspective. Statements by government officials saying that there are ongoing studies that would serve as the basis for potential additional support to the economy are encouraging.

**At the end of 2020, public debt will probably exceed 60% of GDP, which is too high for Serbia.** Serbia entered 2020 with a public debt of about 53% of GDP and a planned fiscal deficit of 0.5% of GDP which would lead to a further decrease of public debt relative to GDP. Instead, the government deficit will amount to about 7% of GDP, which, together with the expected GDP drop of 3%, will lead to a strong increase of the public debt to about 61% of GDP by the end of 2020. With such an increase, the share of public debt in GDP will return to its mid-2017 level, i.e.

in a single year, the entire public debt decrease that Serbia had achieved in almost three years of balanced fiscal policy will be overturned. From a more optimistic side, we should point out that the generally responsible fiscal policy from recent years has now allowed the government to take out such large loans and assist the economy in weathering the first impact of the crisis. Had Serbia encountered this crisis just a few years prior, with a public debt of over 60% of GDP, such a support package would hardly have been possible. It is thus important to begin decreasing the public debt in 2021 already, to lead the country out of the vulnerable zone it is now inhabiting again, as soon as possible.

**Fiscal stabilisation is one of the key preconditions for future economic recovery.** In the previous economic crisis in 2009, the initial GDP drop in Serbia was also smaller compared to majority of other European countries. In 2009, Serbia's GDP dropped by 2.7% while the average GDP drop in EU countries amounted to 4.3%, with the Baltic countries taking the hardest hit, with their economies plummeting by about 15%. However, after the first wave of that crisis had passed, Serbia failed to implement a fiscal adjustment and the necessary structural reforms in a timely manner, opting to maintain the excessive fiscal deficit and allow a strong public debt growth for years. To make matters worse, under the pressure of the unsustainable public debt growth, spending was cut in the politically easiest, but economically least favourable manner - by decreasing public investments. Hence, after several years of steady decline, public investments recorded their historical minimum of about 2% of GDP in 2013 and 2014. Such policies led to several years of economic stagnation and, finally, far more painful measures of fiscal consolidation once it finally began in 2015. Unlike Serbia, the majority of other CEE countries began their fiscal consolidation in time, maintaining the share of public investments in their GDPs at over 4%. Together with the strengthening of their institutions and conducting set of reforms aimed at accelerating economic growth (which Serbia has not yet implemented), this led to a decade of relatively high GDP growth, in which the gap between Serbia and CEE countries got wider, in terms of economic development and living standard.

**A fiscal deficit of about 2% of GDP in 2021 would be a suitable objective for Serbia, as this deficit would prevent the further rise in public debt.** Serbia should not allow the same mistakes from the past to be repeated, as that scenario could easily cost it another decade lost in terms of economic development. This is why it is necessary to restore the shaken fiscal stability as soon as possible, after it had been damaged during the 2020 crisis. This means, primarily, stopping the further rise in public debt - otherwise, expenditures on interests could easily set the debt on another downward spiral, which would be difficult to break later. Even though it may seem, at first sight, that this hazard is not very likely since numerous EU countries have public debt exceeding 60% of GDP, the issue is that the interest rates for Serbia are significantly higher, meaning that the debt is more expensive to pay off compared to those countries. For instance, Germany, with its public debt amounting to about 60% of GDP in 2019, was paying only 0.8% of GDP for interests, while Serbia, with a lower public debt (below 55% of GDP) spent, in the same year, 2% of its GDP on interests - now, this non-productive expenditure will be significantly increased due to the loans taken out in 2020. To stop the further increase in public debt, it is necessary to have a strong deficit decrease in 2021, from its high level of about 7% of GDP. According to our preliminary assessment, a good target for 2021 would be fiscal deficit at about 2% of GDP. *First*, such a deficit would stop, and probably even overturn the growth of the public debt ratio. *Second*, it would not be too restrictive as to undermine economic recovery. *Third*, it is achievable, since the majority of measures that had increased the deficit in 2020 were temporary and would not repeat in 2021 (at least not to the same extent). *Fourth*, a deficit of 2% of GDP would be a good starting point, from which Serbia would restore its fiscal deficit to the level of long-term sustainability, at 0.5% of GDP.

**Budget adjustment in 2021 should be brought about primarily by controlling pensions and salaries in the public sector, and certainly not by decreasing public investments.** The next question is how to achieve the necessary adjustment in 2021 in the best possible manner. Any tax increase would be out of question in the current circumstances, when the economy is "on its knees", so the savings have to come from the expenditure side. The second mistake from the previous fiscal imbalance period (2010-2014), which should be avoided now, is to save by cutting public investments. It was not public investments, but public sector salaries and (to a lesser extent) pensions that were increased unsustainably in 2020. Before the crisis began, at the end of 2019, the government increased the salaries of its employees by almost 10%, which would have been an excessive raise even had the planned GDP growth of 4% been achieved in 2020. Now, with a recession in place of GDP growth, dynamics of salaries in the public sector are opposing economic flows, which finance them. The issue of pensions is somewhat smaller, as in 2020 they were increased by 5.4% by using the "Swiss" formula. Hence, the main principles of a responsible fiscal policy in 2021 would be: 1) control of pensions and salaries in the public sector, and 2) preservation, i.e. moderate increase of expenditures on public investments. These principles are more important than the mere value of the deficit in 2021, as the deficit will depend on the factors that are currently difficult to predict and control (especially if the crisis is prolonged).

**Salaries in the public sector should be frozen in 2021.** Employees in the public sector are currently well protected, in the economic sense. Their jobs and wages are still not in question - which does not apply, to the same extent, to the employees in the private sector (which fund the public sector through their taxes). At that, the unjustifiably high increases of salaries for the public sector employees, which have been occurring for the past several years, have increased the public-private sector pay gap to over 20%, and it will be additionally increased in 2020. We estimate that, for now, there is no need to decrease the salaries in the public sector; however, any increase in 2021 would be fiscally and economically irresponsible. Salary freeze in 2021 would have to apply to employees paid directly from the budget, but also to those who work in public enterprises. It would be inappropriate, for example, if employees of EPS (company that has been struggling for years) were to get a new raise in 2021, while their average net salary is about 100,000 dinars, i.e. 80% higher than the average in the private sector. It would be particularly bad if a part of any electricity tariff increase (which has been lately hinted at in public) was to be used to give the employees a raise, as has happened in the past. Our analysis from 2019 shows that excessive expenditures for employees are one of the most prominent issues of this enterprise, so it would be pointless to use the resolution of one issue (non-profitable tariff) to deepen another (excessive expenditures on employees).

**A moderate increase of pensions could continue in 2021, but it would have to be regulated within the existing structural framework, by building on the "Swiss" formula - and not, in any case, by an *ad hoc* decision from the Government.** One of important legacies of the European pension systems is that increases in pensions are based on objective economic parameters and not on discretionary decisions of the Government. This principle was abandoned in Serbia in the previous years, only to be re-established, with great difficulty, at the end of 2019 with the adoption of the "Swiss" formula. The current economic crisis, however, opens the issue of a sustainable level of pensions for 2021. In the usual years of economic growth, the "Swiss" formula gives an economically good result. But in times of recessions this formula is too simple to serve as a suitable tool to determine the appropriate percentage of pension increase. This problem, however, has a relatively easy structural solution. A small modification of the “Swiss” formula would provide for a somewhat slower growth of pensions in times of crises, and a faster growth during the periods of high economic growth. This is exactly the version of the “swiss” formula that the Fiscal Council proposed in 2019. In the concrete case, this would mean that the pension increase in 2021 would be defined as 75% price growth and 25% average salary growth, leading to a pension growth of about 3% in 2021. What is certainly most important is to keep this issue within the structural, objective, and predictable framework and not to have it become a matter of *ad hoc* Government decisions in the budgeting process.

**In 2021, public infrastructure investments should be increased and the financing can be secured by decreasing the excessive investments into the security sector.** Increased development of infrastructure in 2021 (if the epidemiological situation allows) is beneficial for multiple reasons  Firstly, there is a vast need for such investments as the state of public infrastructure in Serbia is very poor compared to other European countries, due to many years of low investments. In addition, this is the best type of public expenditure for economic recovery. It should especially be kept in mind that this crisis will drastically decrease foreign direct investments in Serbia, which had been an important motor of economic growth in the previous years. Increased government investments into infrastructure would make up for a part of the loss of these investments, in the short term. We therefore recommend that investments into infrastructure be increased by about 0.5 pp of GDP in 2021, compared to 2020. This increase would not jeopardize the fiscal deficit in 2021 as the majority of these funds can be secured by decreasing the excessive investments into the security sector (military and police). These investments have been exceptionally high for several years (and have remained high in 2020), and they have almost no positive effect on economic growth. Specifically, in the previous three years, the government spent almost three times more funds (relative to GDP) to equip the army and the police than other CEE countries - and now the priorities should be changed. The greatest investment increase is needed in healthcare, education, environment protection and communal infrastructure, which have all been neglected for decades and are in dire condition. Projects such as the construction of sports facilities should certainly not be a priority at this time.

**Insufficient and imbalanced government expenditure on investments can best be seen from the poor state of the healthcare system - which should finally be corrected.** For years, the Fiscal Council has been pointing out that the public investments into the healthcare system are insufficient - same as in education, environment protection and communal infrastructure. However, as a rule, these topics only gain importance for a government after the citizens are directly affected (e.g. floods, discharge of wastewaters etc). Healthcare has not received sufficient investments for decades, which is why the objective indicators that measure the equipment and quality of service provided by the Serbian healthcare systems are so low. By 100,000 population, public healthcare in Serbia has half the CT scanners, gamma-cameras, and radiotherapy units and as much as 3-4 times less PET scanners, MRIs, and angiography units than public healthcare in CEE countries. At that, Serbia lacks medical staff, especially specialist physicians and surgeons. Healthcare system resources are at an ever-growing discrepancy with the increasing demand for healthcare services, which is reflected in the waiting lists for particular examinations that keep getting longer. Only in Belgrade, in the period 2016-2018, about 30,000 people per year were waiting for one of the examinations, which is 30% more than in 2007. For over a decade, the government has failed to reconstruct the largest clinical centres, even though the funds for this reconstruction had been secured in 2006. So far, only the reconstruction of the CC Niš has been completed, reconstruction and additional development of CC Serbia and CC Vojvodina are underway, and the works on the reconstruction of CC Kragujevac have not even begun yet. Bearing in mind the project value (about 400 m Euros) and its significance for the improvement of tertiary healthcare quality, such a neglectful attitude of the government cannot be justified. Taking all this into consideration, we believe that, due to the enormous lag, government investments into healthcare in Serbia in the upcoming several years would have to be significantly higher than those in other CEE countries - the same as the investments into the security system had been in recent years.

**Even in a crisis, the government must not lose control over the budget process.** The Government's obligation to budget and spend public funds responsibly and present the execution of the budget transparently applies in a crisis, too. Hence, supplementary financial plans of the mandatory social security funds (NHIF, PIF, NES) would have to be adopted as soon as possible, in line with legal requirements. In addition, the poor practice of using the budget reserve for expenditures that are not extraordinary continues, which is especially problematic during this healthcare crisis. The main goal of the budget reserve is to leave a certain space for the Government, in line with the Law, to be able to redirect a part of the public funds outside of the budget plan - in case of natural disasters (earthquakes, floods) which cannot be foreseen in the budget, for example. The budget reserve is especially important now for the funding of urgent expenditures, primarily from the healthcare domain, which could not have been envisaged in the supplementary budget. It is therefore very unusual to see this important public resource now used to fund expenditures that cannot be classified as extraordinary or urgent by any criterion. Individually, the largest such expenditure is the donation made to the Serbian Orthodox Church for the completion of development and reconstruction of the Memorial Temple of St. Sava in Belgrade, reaching 1.2 bn dinars in total. Reconstruction of this Temple began several decades ago (the last stage began in 2000s, after a pause during the 1990s) and has already been funded from the budget before. It is hence unclear why this expenditure could not have been planned earlier - in the supplementary budget adopted just months ago - but is being executed from an overly sensitive public resource.

**The relationship between the epidemiological measures and public finance goes both ways, which means they need to be coordinated well.** It is clear that epidemiological measures (and the increased expenditures for healthcare in general) depend on the national budget from which they are funded. There is a solid link between the two on the other side, as well, as epidemiological measures affect economic activity and, consequently, public finance. In recent months, statements had been made in public arguing that the relaxation of epidemiological measures is needed for economic reasons, as well. More caution is needed, however, when making such statements. In general, it is true that a relaxation of epidemiological measures has a favourable effect on economic activity, but by far the worst-case scenario for the domestic economy and public finance is to have the healthcare crisis flaring up every few months. It is much better for the economy to operate, even for a prolonged period, with moderate limitations than to undergo severe shocks several times. It would thus be good to make at least general analyses of the impacts of individual epidemiological measures on the economy and the budget, instead of arbitrary statements that any relaxation of measures is an economic necessity. As an illustration, some economic activities such as organizing large events are not of such great economic importance but could be of great epidemiological importance. The budget has already paid out enormous funds to support the economy during the state of emergency, and it would be a shame to gamble away the gains from this sacrifice, even if that meant that certain epidemiological measures, which impede economic activity, would be left in effect longer.