Republic of Serbia

FISCAL COUNCIL

OPINION ON FISCAL STRATEGY DRAFT FOR 2020 WITH PROJECTIONS FOR 2021 AND 2022

Summary

The Fiscal Strategy Draft prescribes a suitable, low fiscal deficit that guarantees macroeconomic stability and represents a good foundation for the Budget preparation. For the first time since 2011, the Fiscal Strategy Draft has been prepared prior to the Budget for following year. This suggests that the legally defined budget calendar may finally be respected; the calendar starts with the making of the Fiscal Strategy, continues with the development of the annual budget and ends with the adoption of the Final Budget statement. An important step in between these is the adoption of the revised Fiscal Strategy at the beginning of October, which provides a firm budget framework for 2020 and plans for 2021 and 2022. The main purpose of objections and recommendations presented in this report is to significantly improve the new, revised version of the Strategy and then to prepare the 2020 Budget based thereon. Adherence to the presented budgeting procedure will allow for the annual budgets to be made in line with carefully considered medium-term goals of economic policy with clear and objective rules on the growth of pensions and salaries in the general government, predictable changes in tax rates, transparent public investments priority lists etc. Starting from these needs, we estimate that this year's Draft Strategy has completed the first part of its journey and we are expecting a significantly improved, revised version in October. Quantitative fiscal goals set in the Draft Strategy are achievable and well chosen. The low medium-term deficit of 0.5% of GDP is adequate for Serbia, as it leads to a further decrease of public debt share in GDP, guaranteeing economic stability. At that, a drop in public debt automatically decreases the budget expenditures on interests opening new fiscal space for the necessary public investments increase while maintaining the deficit at the unchanged, low level.

Good quantitative objectives, however, are not accompanied by a credible structural reform plan. As we have hinted, the Draft Strategy is on the right track to become a credible medium-term fiscal policy document, but it is not quite there yet. For complete public finance recovery and sustainable economic growth acceleration, a number of structural reforms missing from the Draft Strategy need to be defined and implemented. A general government wage and employment system reform (which has been postponed for a number of years now) is postponed again in the Strategy, with no concrete indications of what it would look like. Within the public investments increase, it is unclear what the concrete priorities of the government are and how they were selected. There's no good plan for a public enterprise reform, the announced tax reform (taxes

and labour contributions cuts) is good in general but it would have to be elaborated in much more detail for the private sector to be able to plan their operations in advance, and the description of activities aimed at improving Tax Administration performance appear more like wandering than like a clear plan of the government for this important institution.

The largest macroeconomic issue in Serbia is the subpar economic growth - and the Fiscal Strategy Draft doesn't offer a suitable solution for it. Economic growth, a key macroeconomic indicator, is crucial for the sustainable increase in living standards. Hence, the quality of fiscal and broader economic policies is assessed not only by the (achieved) macroeconomic stability, but also by the rate of the country's economic growth. Growth of Serbian GDP has not been satisfactory for years, i.e. it is significantly slower than that of other countries in Central and Eastern Europe. In the previous three years, Serbian GDP growth amounted to, on average, 3-3.5 % whereas other CEE countries had 4-4.5% growth rates in the same period. To make matters worse, Serbian economic growth has additionally slowed down since the second half of 2018, which has not happened in the comparable countries. All this indicates that the economic policies in Serbia are not sufficiently incentivizing economic growth and that they have to be improved and corrected in short and medium term - which the Strategy, as the Government's most important strategic document for economic policy, would have to address. The Draft, however, mostly ignores this problem and only partially addresses the issue. The most important policy measures from the Draft Strategy that can have a positive impact on economic growth are the planned public investments increase and a decrease on the fiscal burden on labour - but they are not enough, nor are they elaborated in sufficient detail. In addition, credible plans for public enterprise reform, business climate improvements (where, e.g. there are enormous problems due to high corruption and insufficient rule of law), improvements in the work of public administration, including the largest public systems (healthcare, education) are also missing. Instead of the necessary fundamental reforms, the Draft Strategy envisages, as measures to incentivize economic growth, digital transformation, "innovation vouchers", amendments to the Customs Law etc., which are not a disputable, but can only serve as a good addition to more comprehensive measures, and not as an appropriate plan of the Government to accelerate economic growth.

The planned 4% GDP growth in the medium term is insufficiently ambitious and the big question is, will it even be achieved? The Draft Fiscal Strategy forecast has Serbia achieving a 4% GDP growth per year from 2020 to 2022; this approximately corresponds to the current average growth of the CEE countries. However, there are two issues with this forecast. The first is that the planned economic growth is insufficient. Namely, after a decade of low economic growth Serbia has dropped to a mere 55% of the economic development compared to CEE average and achieving a 4% economic growth is insufficient to start closing the gap. The second issue is that it is not at all certain that the forecasted economic growth will be achieved. Year-on-year GDP growth in the first quarter of 2019 came in only at 2.5% (in other CEE countries, it was 4.3% on average) and it will be a challenge to reach the planned economic growth rate of 3.5% in 2019. And if even the relatively moderate growth rate of 3.5% in 2019 is not achieved, further acceleration and achievement of GDP growth of 4% in 2020 will be very uncertain, all the more so because the forecast economic growth acceleration is not supported by the appropriate policy measures in the Draft Strategy.

The planned fiscal deficit of 0.5% of GDP is a well-chosen objective leading to a further decline in public debt to GDP ratio. Draft Fiscal Strategy plans to maintain the consolidated government deficit at the same level in 2020-2022 as in 2019, at about 0.5% of GDP. Such a low fiscal deficit is suitable for Serbia, as it guarantees macroeconomic stability on one hand, while on

the other it has a favourable effect on the country's economic growth. A further decrease in public debt is necessary to ensure macroeconomic stability, since the current level of a little over 50% is still too high for a country at Serbia's level of development. A deficit of 0.5% of GDP leads to a decrease in public debt compared to GDP by about 2 p.p. per year, which is a satisfactory rate of decrease. On the other hand, this deficit is not overly restrictive, as it has already been achieved in structural terms - i.e. it does not envisage further austerity measures and allows for an increase of expenditures for pensions and salaries in the general government approximately in line with GDP growth. Moreover, a further decrease in public debt share in GDP lowers future government expenditures on interest, freeing up additional fiscal space for a public investments increase and a reduction of certain tax rates in the medium term (a part of the decrease of expenditures on interests comes also from a decrease in interest rates for government loans, due to stabilizing public finances). Finally, continued stabilization of public finances together with a public debt decrease are also well-chosen objectives because they will have a positive effect on the country's credit rating and borrowing conditions, not just for the public, but for the private sector as well.

A fiscal deficit of 0.5% of GDP in the medium term is credibly planned in general, but the forecasts of individual budget items need to be reconsidered. A check of public revenue and public expenditure forecasts from the Draft Fiscal Strategy shows that they are, in general, suitable - which means that their result, i.e. a fiscal deficit of 0.5% of GDP is credibly planned. However, in forecasts of individual budget items, there are certain, minor inconsistencies that the Ministry of Finance should rectify (or clarify) in the revised Fiscal Strategy. For example, the Strategy plans for an increased share of contributions in GDP in the medium term, meaning that the contribution collection shall be growing faster than GDP. Perhaps this would not be so unusual if it hadn't been forecast, at the same time, that the salaries in the private sector shall grow in line with productivity growth and the salaries in the public sector shall grow slower than those in the private sector - which, by definition, means that the contribution base (wage bill) will grow at the same rate, or somewhat slower than GDP growth. Therefore, in the Draft Strategy, the contribution collection has not been planned consistently with the forecast trends for its base. In line with that, perhaps the pension trends forecast should also be checked - the share of pensions in GDP is relatively sharply decreased (in 2022, it is by about 0.6 p. p. lower than in 2019). It has been announced that the future pension indexation shall be implemented according to the "Swiss formula", including the average salary trends - so perhaps a somewhat higher growth of pensions should be considered, all the more since a relatively high contributions growth has been planned. At that, the VAT forecasts are somewhat higher than the current Fiscal Council forecasts, both in 2019 and in the medium term, which should also be checked when developing the revised Fiscal Strategy.

It is good that the Strategy calls for improvement and reaffirmation of fiscal rules. The achieved fiscal stability now needs to be ensured on a permanent legislative basis through amendments that would solidify the existing fiscal rules - as is announced in the Fiscal Strategy Draft (although not in detail). The basic parameters of new fiscal rules should not be so different from the previous rules. Two key anchors for public finance stability are: 1) prescribing the maximum allowed level of public debt and 2) obliging the government to keep a permanently lower deficit (with temporary oscillations allowed for the needs of counter-cyclical fiscal policies). Maximum public debt level in Serbia would certainly have to be lower than the Maastricht limit of 60% of GDP, as Serbia is less developed than EU countries and the danger of a public debt crisis arises at far lower levels. This is why certain CEE countries which are EU members set the maximum public debt level far below 60% of GDP in their legislation (Poland, Slovakia). A

permanent fiscal deficit should be prescribed at about 0.5% of GDP until the share of public debt in GDP drops down to a sustainable level; after that, allowing a slightly higher structural deficit would probably be justified (e.g. 1% of GDP). Along with the public debt and deficit, fiscal rules should also prescribe a sustainable indexation of pensions and salaries in the general government, as these are by far the largest public expenditures that, if they are allowed to grow unfoundedly, would cause the public finance to collapse sooner or later (even if, at first, they did not endanger the deficit). It will be a somewhat greater challenge to define sanctions and procedures for breaching fiscal rules than it was to set quantitative values for them, since experience from previous fiscal rules shows that such sanctions and procedures are necessary; at that, a large number of technical details need to be prepared, so that the new system of rules would become operational.

An important improvement from the Strategy is the introduction of the economically justifiable "Swiss" formula for pension indexation, instead of the current *ad hoc* approach to their increase. Pensions are the single largest budget expenditure, so a sustainable and regulated pension system, based on objective parameters, is of critical importance for public finance stability. The Fiscal Council has criticized the exaggerated influence of the executive government on the pension system several times over the last two years. First, we opposed the unjustified extension of the temporary pension cut, as the conditions for its cancellation had already been met in early 2018. The Government did suspend this temporary measure at the end of 2018, with a delay of almost a year; however, at the same time it made a new mistake that the Fiscal Council also criticized - it unnecessarily revoked the mechanism of automatic indexation (increase) of the pensions based on objective parameters. Instead, the current legislative solution envisages that the Government should prescribe, in line with available fiscal space, the extent of pension increase - which gives the Government excessive discretionary power that is uncommon in other European countries. The Fiscal Strategy announces a departure from this unusual, *ad hoc* practice with the pensions indexed according to the "Swiss formula" in the future (a combination of the growth of consumer prices and average salary). This model of indexation is relatively simple, economically justified and familiar in Serbia, as it was already in place in 2000s. An important addendum that would ensure a lasting sustainability for this model would be to define a range of 9.5% to 10.5% of GDP as a limit for government expenditures for pensions. That would mean that the "Swiss formula" would be temporarily suspended if the share of pensions in GDP was to exit this range. In concrete terms, if the share of pensions were to exceed 10.5% of GDP, they would be indexed only according to the inflation; but it would also allow for their irregular increase if the application of the "Swiss formula" were to lead to their share in GDP becoming too low (below 9.5% of GDP).

The Strategy doesn't provide sufficiently good elements to reform the wage and employment system in the general government and the introduction of pay grades has once again (without explanation) been postponed. The process of bringing the wage and employment system in general government into order began five years ago, but has still failed to bring any concrete results. As a matter of fact, in the meantime, the system has collapsed additionally due to *ad hoc* increase of salaries in individual sectors (which have been implemented since 2016) and extension of the employment ban (which should have been lifted back in 2015). The Draft Strategy now envisages two main measures for the regulation of the salary and employment system in the general government: 1) introduction of pay grades that, after another postponement, has now been announced for mid-2020 and 2) termination of the employment ban from the second half of 2019. However, the first measure is not credibly planned, while the second is insufficient to permanently solve the problem of poor employment structure. In order for the announcement of pay grades

introduction to have the necessary weight, it would have to be accompanied by concrete parameters - defining a range between the lowest and highest salary, deadlines in which the currently exempt parts of the public sector (police, army) would enter the single legislation, deadline for the publication of a detailed register of employees and their salaries etc. The insufficient credibility of the Government's announcements promising to reform the wage system is illustrated even more convincingly by a new postponement of pay grades introduction (from the end of 2019 to mid-2020). This indicates that the most likely primary reason for which this reform has not been implemented for years is the lack of political will to do so. The second measure, abolition of the employment ban, was necessary as it was the prolonged duration of the ban that has led to serious shortages of staff in important parts of the public sector. The mere repeal of employment ban is insufficient for a sustainable and good managing the number of employees in the general government; it needs to be used to rectify the current major issues. At the same time, the Government should perform a thorough analysis of public sector needs, to define precisely how many employees and with which qualifications are needed in each individual government sector. Doing so calls for the making and implementation of sectoral reform plans (education, healthcare).

An acceptable public investments increase to 4.6% of GDP has been planned in the medium term, but it would be good to have the concrete purposes defined, as well. Many years of insufficient public investments are among the largest structural problems of Serbian public finance, which is why the Fiscal Council has constantly been emphasizing the need to increase budget expenditures for investments. Public investments increase is necessary due to the very poor state of the infrastructure, but also as an important incentive for economic growth both in the short term (while the works are ongoing) and in the long term (due to the improvement of infrastructure quality). The Draft Strategy calls for a gradual increase of the share of public investments in the GDP, from the current 4% to 4.6% in 2022, which is a significant improvement from the previous Strategy which planned for a stable share of public investments in GDP of 4% in the medium term. Important information which, however, is missing from the Draft Strategy is the list of priority projects that the planned public investments increase pertains to. Without it, it is impossible to know whether and by how much the investments in priority areas, which are in direct need and which would have the largest effect on economic growth (road and railroad infrastructure, environment protection, healthcare and education), will increase, or if the Government's priorities perhaps lay in the construction of sports facilities, buying military and police equipment etc.

The announced tax and contributions cut is generally a good economic policy that should be further developed. The Fiscal Strategy has correctly recognized that the future tax relief of the economy should be directed at lowering the fiscal burden on labour (contributions and personal income tax). This would lead to a decrease in production costs for the domestic economy, providing a good incentive for GDP growth - which would not quite be the case if the tax relaxation was implemented through the consumption tax (VAT, excise) as that would also incentivize import growth. Also, bearing in mind the current tax rates in Serbia and CEE countries, it can be seen that the largest relaxation space is in the contributions and personal income tax, as other tax rates in Serbia are already among the lowest in the region (corporate income tax, for example). The Fiscal Council, therefore, strongly supports the Government's intention to reduce the fiscal burden on labour in the medium term, but we note that the next important step should be to determine the target level of personal income tax and contributions on salaries in the revised Fiscal Strategy, as well as the period and dynamics of adjustment in the upcoming years. This would improve the predictability and credibility of the tax policy, allowing the private sector to plan their investments and other business activities in advance.

Tax Administration modernization and performance improvement are of pivotal importance for an adequate functioning of the tax system, but this process is accompanied by unnecessary delays. In the last two years, progress has been made only in certain segments of Tax Administration reform (decrease of the number of Tax Administration branches), while many important measures are not being implemented as planned. One of the major problems is the fact that there is still a pronounced shortage of qualified staff in key positions, such as Tax Inspectors. The previous permission of the Government to employ 100 new staff in the Tax Administration was insufficient to provide adequate capacity reinforcement; the large number of rigid legal and administrative rules and procedures still prohibit the Tax Administration from paying their employees in line with their performance and competitively compared to the private sector. In addition, although one of the priorities set already in the Tax Administration Transformation Strategy from 2016 was the recognized problem of the non-tax competencies that represent an operational burden on the Administration - the progress achieved so far is minimal and disappointingly slow, indicating insufficient dedication of the Government to build a modern and powerful Tax Administration. On top of that, additional risks now appear in the form of managing the professional aspects of the initiated reforms. Although the IMF experts had supervised and assisted the Tax Administration reform from the professional side in the last decade, the Serbian Government is now planning to take out a 50-million-dollar loan from the World Bank and to bring their experts to support the tax administration reform. This decision will necessarily lead to several months of delay of the transformation process, which had been recognized and well defined several years ago.