Republic of Serbia

Fiscal Council

ASSESSMENT OF THE DRAFT BUDGET FOR 2020 AND REVISED FISCAL STRATEGY FOR 2020-2022

Summary

Given the predefined parameters, the proposed budget for 2020 is relatively well planned. The biggest economic mistake in the planned budget policy in 2020 had already been made prior to the elaboration of the 2020 budget - in the 2019 supplementary budget. This supplementary budget defines an exaggerated increase in salaries in the general government, of an average 9.6% (significantly exceeding economic growth) which exhausted a large portion of the 2020 budget funds in advance. The majority of the remaining funds have been allocated well, which is why in general the Fiscal Council assesses the proposed 2020 budget as positive. Overall expenditures have been planned mostly on par with the revenues, i.e. an appropriate, low state government deficit of 20 bn dinars has been planned (0.3% of GDP). Revenue and expenditure forecasts are good and conservative, so there is no pronounced risk of the deficit spiralling out of control. On the contrary, the deficit could easily be lower than planned. Finally, the budget includes a solid increase in public infrastructure investments, while the revenue side incorporates a decrease in the tax burden on salaries - which are good measures that, however, could have been more significant had the general government salary increase been smaller and fiscally responsible, i.e. in line with economic growth.

State revenues have been planned well and conservatively in the 2020 budget, and the implemented tax policies point in the right direction. When it comes to revenue budgeting, the Fiscal Council asserts that they have been planned cautiously and in line with good budgeting practice. Specifically, excise tax revenues, profit tax revenues and non-tax revenues could easily come in above the budget plan, while we perceive that there is a limited risk that only VAT revenues might be collected in the amount lower than planned. Important changes in tax policies related to the relaxation of the fiscal burden on labour, which will have a sizeable impact on the budget, are planned for 2020. A decrease in total taxes and contributions on salaries, from 62% to 61% of the net salary has been planned; it will entail a decrease in the pension insurance paid by the employer, from 12% to 11.5% of the salary, and the non-taxable share of salaries will be increased from 15,300 to 16,300 dinars. The Fiscal Council supports the Government's economic commitment to use the available budget funds to relax the burden on salaries (our most important objection is that conditions had not been made to make this relaxation even larger).

Budget expenditures have been planned adequately, with a partial improvement in their composition. State expenditures present a good reflection of the policies and measures

planned for 2020 and there is no significant risk of them exceeding the plan. Actually, it seems that not all budgeted transfers, interests and expropriation will be used, whereas the minor risk of exceeding the budget plan pertain to penalties and to public expenditures (economically, it would not be bad if the plan was exceeded due to increased infrastructure construction). The largest expenditure increase compared to 2019 relates to the wage bill for employees, but this increase had already been defined in the 2019 supplementary budget, meaning that the proposed budget only formalizes the known budget expenditures for this purpose. If salaries are excluded, the 2020 budget brings an improved public expenditure composition. Namely, the second largest increase compared to 2019 (second to salaries) is in public investments, which should be about 150 m Euros higher. Within this increase, we point out that investments into healthcare, education and traffic infrastructure (including land expropriation) are increased even more (by about 200 m Euros), while this additional increase has been made possible by the fact that economically unproductive expenditures for military and police have been decreased (despite the planned decrease, these expenditures remain at a relatively high level in 2020 as well - over twice the average of other CEE countries).

The worst budget policy in 2020 pertains to an excessive increase in salaries and the overall inadequate management of the remuneration and employment system in the general government. As we have already pointed out, the largest change in budget expenditures in 2020 compared to 2019 is in the wage bill, which was made even before the budget itself was considered - a highly unusual and bad practice. However, the fact that the general government salary increase had been defined a month sooner than prescribed is probably the smallest issue related to public sector salary management. The fact that the salary increase of as much as 9.6% on average is too high and economically unfounded poses a far greater problem. This violates one of the main principles of a responsible fiscal policy: that salaries in the public sector should not grow faster than the entire economy. Furthermore, the increase was implemented arbitrarily in different sectors of public administration, with no objective or verifiable analysis of which jobs require a higher - and which require a lower salary increase. Such arbitrary salary increases drive Serbia away from the introduction of a systemic solution of uniform pay grades for the entire general government (which was announced and then postponed several times throughout the years). At that, in 2020, the harmful employment ban in the public sector will remain in force - even though the Government had envisaged a transfer to a more flexible employment model in the public sector in the Fiscal Strategy draft, written just a few months prior to the budget. The employment ban should have been lifted back at the end of 2015; the fact that its duration was extended for many additional years led to serious shortages of staff in the important segments of the public administration, but also to a deterioration in employment composition. Namely, as a response to the employment ban, the budget beneficiaries increased, by almost 50%, the number of employees on termed contracts and on temporary-intermittent job positions in 2019 compared to 2014, as employment ban does not pertain to these types of contracts.

The planned public investments increase is generally good but there was no increase in investments in communal infrastructure and environment protection, unjustifiably so. The 2020 budget maintains approximately unchanged expenditures for traffic infrastructure development compared to 2019, but with a somewhat altered composition (higher expenditures for railways and river traffic, lower for roads). We see this plan as positive, as it means there have been no delays in the development of the traffic network, after the completion of some major projects (Corridor 10, sections of Corridor 11). The most important positive change in 2020 is the increase in investments in education and partly in healthcare. The 2020 budget plans for investments in education in the amount of 22 bn dinars, up by almost 60%, or 8 bn dinars, compared to 2019. The individually highest amount of about 12 bn dinars is intended for the continued reconstruction and construction of primary and secondary schools and it is funded from the budget of the Public Investment Management Office. The remaining 10 bn dinars is allocated to the projects of the Ministry of Education, such as education system digitalization, procurement of teaching materials and other equipment, as well as introduction of wireless internet in schools. In addition to education, the Budget also envisages an increase in investments in healthcare by about 40% (from 5 to 7 bn dinars). The most important projects in this line are the continued construction and reconstruction of clinical centres in Serbia and procurement of equipment for healthcare institutions. An important shortcoming of the public investment plan in 2020, however, is the fact that no expenditures have been planned for communal infrastructure and environment protection - even though this is perhaps the most neglected segment of public infrastructure in Serbia, one that presents a serious hazard for the health of Serbia's population. The loan announced for these purposes does not guarantee the beginning of investing, as the same loan had been envisaged in the previous budget and the implementation has not even begun. Hence, the Fiscal Council recommends to the Government to direct any surplus funds that may appear in 2020 due to the cautious planning of public revenues and public expenditures, to these purposes.

The Government would have to prepare a strategic response to the manifold increase in non-productive expenditures for penalties, in just a few years. The Government's expenditures for penalties shall exceed 22 bn dinars in 2020, i.e. twice as much as in 2017 and over five times as much as in 2010. Even though the Fiscal Council has been emphasizing the uncontrolled growth of this item of public expenditures for years, there is still no strategic, thought-out reaction from the Government to this bad trend. It is interesting to note that this problem is rarely mentioned among both expert and general public, even though the budget expenditures for penalties are twice as high as subsidies for investors. The majority of these expenditures comes from the damages the government has to pay for breach of contract. We would like to recall a few past cases: In 2014, 1.6 bn dinars were paid to private companies for failure to meet obligations for the concession for the construction of the Horgoš-Požega highway; in 2018, about 4 bn Euros were paid to the Greek Mitilineos company for the dispute with RTB Bor. It is now known that the 2020 budget allocates funds for damages to be paid out to Energo-Zelena (in an unknown amount) and, judging by the record-breaking amount allocated on the Ministry of Finance line, it is definite that the government has lost another major court case or international arbitration. For all these reasons, the Fiscal Council believes that the Government must finally make a serious analysis that would identify, precisely, the main reasons why they have lost so many court cases. In line with the findings of such analysis, specific measures would have to be implemented so that the strong growth trend of these non-productive budget expenditures would be overturned in the upcoming years.

Medium-term plan for public finance management from the revised Fiscal Strategy is not adequate, as there is no credible plan of important reforms. Before adopting the Budget proposal for 2020, the Government adopted the revised Fiscal Strategy for 2020 with forecasts for 2021 and 2022. Despite the fact that this strategic document contains certain positive steps, Fiscal Council finds that it does not comprise all necessary elements, or not in their properly elaborated form. This Strategy actually indicates that the Government is complacent with the achieved fiscal and macroeconomic stability, and that the implementation of important structural reform is not a priority of economic policy. Namely, in the revised Strategy, the unique and objective pay grade system for general government employees is postponed further (and it should have been adopted years ago); there is no concrete plan to lift the harmful employment ban in the public sector (which should have been terminated in 2015), no structure is provided for public investment in the medium term with clear priorities for government investments etc. In line with its legal obligations, the Fiscal Council submitted its opinion on the Draft Fiscal Strategy in May 2019 to the Government, comprising (inter alia) all the aforementioned objections. In the following step of elaborating the Fiscal Strategy, the Government had an obligation to adopt the objections of the Fiscal Council – or, if any of them had not been adopted, to list them and explain why (Budget System Law). However, there is no such explanation in the revised Fiscal Strategy.

Comprehensive structural reforms are needed because Serbian economic growth is low and far below its potential. The fundamental economic issue in Serbia is its insufficient economic growth, and consequently the low living standard of its population. The GDP growth trend in Serbia has been between 3 and 3.5% for several years, while other Central and Eastern European (CEE) countries have shown an average growth of 4% in the last three years. That means that these countries are widening the growth gap, instead of Serbia gradually catching up with them through faster economic growth. It is important also to point out that there are no reliable indications in 2019 that there will be a sustainable trend of accelerated economic growth in Serbia, despite the fact that a significantly higher GDP growth is expected in the second half than in the first half (in which GDP growth reached only 2.8%). The temporary acceleration will take place, all things considered, primarily under the strong impact of one-off factors (construction of the Turkish Stream, higher production in Kolubara), which would not be the first time that temporary factors determine the economic growth level in the short-term. A similar thing occurred in 2018 when GDP growth temporarily accelerated to 4.4% due to a major acceleration in agricultural growth or, conversely, when the drought of 2017 knocked down the economic growth rate to a mere 2%. Hence it would be good for the Government to adopt cautious and responsible interpretations of the economic trends and not to expect them to show any permanent improvement without serious and comprehensive structural reforms. The only way to accelerate economic growth permanently is to implement public enterprise reform (primarily in EPS), to improve the business climate (e.g. enormous issues with high corruption and insufficient rule of law), improve the work of public administration including the largest public systems (healthcare, education) etc. – which would require a far higher commitment from the Government than we have seen so far.