Republic of Serbia

FISCAL COUNCIL December 8, 2017

OPINION ON FISCAL STRATEGY 2018-2020

Summary

The Fiscal Strategy is not a good enough plan for public finance management in the medium term, as it fails to answer some of the biggest challenges of fiscal policies. The purpose of the Fiscal Strategy is to clearly identify fiscal policy objectives and guidelines in the upcoming three years. The widest of these objectives - a permanently low fiscal deficit of 0.5% of GDP, is quite well and plausibly defined in the Strategy. However, numerous important issues that need to be resolved by 2020 are left open, with some of them not even mentioned. *First*, the Strategy does not present the government's plan for the exit from the temporary "crisis management" fiscal consolidation measures introduced in November 2014, even though the imminent danger of a public debt crisis has passed; so, for example, there's not even a hint of when the Law on Temporary Regulation of Pensions, reducing the above-average pensions and disrupting the economic relationship between the contributions paid in and pensions paid out, shall be repealed. *Secondly*, there is no plan in the medium term for a substantial improvement in public revenue and expenditure structure compared to 2018 - public investments will remain at the approximately same level as in 2018 till 2020, at about 3.6 - 3.7 % of GDP, even though the need for their further increase to over 4.5 % of GDP is very pronounced, especially in the areas of environment, education and healthcare. *Thirdly*, the Strategy fails to envisage sufficiently firm and good structural reforms, primarily of state-owned and large public enterprises - for example, it does not identify the final deadline or a detailed plan to resolve the fate of all enterprises undergoing privatisation. *Fourthly*, the large problems of local public finances have not been recognized either; needs and possibilities for the improvement of the catastrophic situation in local public utility infrastructure (access to clean drinking water, non-engineered landfills, wastewater treatment etc.) would have to be considered within this item.

The Fiscal Strategy plans for a low fiscal deficit of 0.5 % of GDP in the long term and, consequently, a gradual decrease of public debt. An almost balanced budget, i.e. low general government deficit of 0.5 % of GDP is planned in the Strategy until 2025 - which is very good and necessary. Namely, a fiscal deficit of 0.5 % of GDP decrees the public debt, relative to GDP, by 2-2.5 pp per year, so its maintenance in the long run would gradually reduce Serbian excessive public debt. In such a case, it could be expected that the public debt would drop to about 60 % of GDP at the end of 2019, and the entry into a safer public debt zone (which economic research place around the 50 % of GDP mark for countries like Serbia) could take place in 2024. Public debt decrease relative to GDP must remain the priority of fiscal policy, not only because it increases Serbia's resilience to some future economic crisis

that could come from the outside, but because it has a positive effect on the improvement of budget expenditure structure and acceleration of economic growth. Namely, decrease of public debt leads to a decrease of the interest payments - by 2020, approximately by 0.6 % of GDP which can then be spent far more productively (e.g. for public investments). At that, decrease of public debt lowers the country's risk and interest rates for loans taken by the private sector, which promotes its investments and economic growth.

A gradual acceleration of economic growth to 4% is planned in 2020, which will take more comprehensive reform. The planned GDP growth of 3.5% in 2018 is achievable (the Fiscal Council even has a somewhat more optimistic forecast). This is because there will be positive effects on growth in 2018 from the expected recovery of agricultural production after the drought and establishment of the usual level of electricity production after the major drop that EPS experienced in the first half of 2017. The first challenge, however, will be to maintain and additionally accelerate this growth in the years to come, when the positive effects of temporary factors stop - as Serbia has structural issues which have kept its economic growth lower than the comparable Central and Eastern European countries for years (with these countries achieving an average growth in 2017 of 4.5%). The "defect" that keeps Serbian economy at a low growth rate, by all accounts, seems to be the lack of investments. In Serbia, private and public sector together invest less than 18 % of GDP, while high and sustainable growth rates exceeding 4% would require the share of investments in GDP to increase to over 22% (regional average). This means that the government would have to increase its expenditures for public investments, but also to reform public enterprises (first of all, EPS) and privatize state-owned enterprises (RTB Bor, Petrohemija) so that these enterprises could enter new investment cycles. Measures aimed at improving the business climate are necessary for the increase in investments of the private sector - primarily small and medium enterprises. The Fiscal Strategy provides only partial answers to all these needs. Public investments are increased by 3.7 % of GDP in 2020; they would need to be increased far more. The presented reform plan for public enterprises is quite vague and lacks credibility; the same goes for the plan for privatization of state-owned enterprises. Finally, the Fiscal Strategy comprises a part that pertains to business climate improvement, aimed at reducing bureaucratic and administrative procedures, improving bankruptcy proceedings etc. This is a good thing, but it still fails to mention some of the key factors of the poor business climate which pertain to enforcement of contractual obligations and rule of law - which is where Serbia ranks very low on the international competitiveness lists.

Increase of budget expenditures for salaries and pensions in the medium term is well planned - in line with nominal GDP growth. Expenditures for salaries and pensions are the highest public expenditures by far, so their meticulous planning and control are of utmost importance for public finance sustainability in the medium term. In other words, due to the level of these expenditures, any major discrepancy that appears in this area threatens to topple the overall public finance system. At that, the nature of these expenditures is such that it is very difficult to bring them back, once they are out of control. A good example for this statement is the extraordinary and unjustified increase of pensions from 2008, which was one of the main reasons why public finances in Serbia ended up in a completely unsustainable situation in the years that followed. We point this out especially because, after the cuts in 2014 and several years of decelerated indexation, salaries and pensions have finally come close to the level that the economy can finance in 2017 (11 % of GDP for pensions and 8 % of GDP for gross 1 salaries). This is why it is crucial not to repeat the same mistakes now, but to have the total expenditures for pensions and salaries in the public sector approximately following the nominal GDP growth, i.e. increasing only in line with the growing economic strength of the country (5 - 7% per year). The fiscal surplus, if achieved in the upcoming years, must not be spent on additional increase in salaries and pensions as this, sooner or later, will lead to issues with the budget. The Fiscal Strategy envisages a good overall increase of pensions and salaries in the public sector in medium term, harmonized with economic growth and we hope that the Government will adhere to this plan consistently.

The Fiscal Strategy doesn't define precisely when the temporary decrease of above-average pensions and decrease of salaries in public enterprises will be repealed. Probably the greatest flaw of the Fiscal Strategy is the fact that it doesn't define, precisely, when the temporary reduction of above-average pensions, which disrupted the economic relationship between the contributions paid in and the pensions paid out, will be repealed. This measure, adopted at the end of 2014, can be justified when the country is in an imminent danger of a public debt crisis. However, this danger passed in 2017, as the public debt has begun its sustainable decline and pensions have practically reached the level that would be adequate in the long run, which is why there are no economic grounds to keep this measure in place. To make matters worse, preservation of this measure could now become a serious fiscal risk, as there are hints of upcoming law suits from pensioners whose pensions are still decreased. These lawsuits could easily prove to be founded, for the period from 2018. The issue with abandoning the temporary decrease of salaries is somewhat smaller, since the introduction of a new salary system in the public sector is planned for 2019, which would automatically repeal the current temporary Law. We would like to point out, however, that the introduction of a new salary system is professionally and politically very challenging, which is why it could end up being postponed further, or result in major compromises that would render it pointless. An illustration of the poor management of the salary system is their arbitrary increase in 2018. Finally, we come to the almost forgotten temporary decrease of salaries in public enterprises. The Fiscal Strategy is silent on when this measure might be repealed, but the forecast of non-tax revenues implies that the Government is not actually planning to repeal it in the upcoming 3 years. The Fiscal Council believes that there is no grounds to maintain this measure in medium term, but upon its repeal, care must be taken not to allow a salary increase to those enterprises which have practically evaded the legislative decrease of salaries in 2015 (EPS).

The Fiscal Strategy fails to plan for a sufficient increase in public investments in medium term. The Government's medium term plan increases the level of public investments from the 2017 level of less than 3 % of GDP to 3.6 % of GDP in 2018, then keeping it approximately at the same level in medium term (3.7 % of GDP in 2020). We assess the planned investment increase in medium term to be insufficient. The usual share of investments in GDP of comparable Central and Eastern European Countries is over 4 % of GDP, while in periods when these countries have an increased level of construction activities for basic infrastructure (highways, railroads), which is the case in Serbia now, this share climbs to over 6 % of GDP. An additional issue that the Fiscal Strategy fails to recognize is the fact that many areas that require investments have been completely neglected for years. This is why Serbia has been assessed as completely unharmonized with the EU in the field of environment. For example, only 25% of waste is disposed in line with EU standards and there are about 3,500 "wild" landfills of which many endanger waters; wastewater is not treated even in the largest cities (Belgrade, Novi Sad, Niš); the low rate of sewers connections makes Serbia the negative record-holder in Europe, etc. Preliminary assessments show that Serbia should invest about 600 million Euros per year in environment protection (instead of the present 60 million Euros). Major investments are needed in healthcare and education as well, where the current annual investments are three times lower than in comparable CEE countries. The only sector where the investments have been planned at a satisfactory level (from 2018) is the construction of road and railway infrastructure, but here, care should be taken to have the planned construction works implemented efficiently, as the level of realisation of these public investments has often been low in the past.

Reform of public enterprises is not planned credibly enough. Of the three fiscally most significant public enterprises (EPS, Srbijagas, Železnice), true reforms have only begun in Železnice. The largest enterprise in Serbia, EPS, is a good example of how poorly Serbia manages its important resources. Due to poor management, this enterprise saw a major drop in production in 2017, significantly lowering the entire country's economic growth - instead of driving it with its sustainable profit and investments. However, the reforms that would turn EPS into a profitable enterprise have been postponed for years. For example, adoption of a systematization that would precisely determine the surplus of staff, then serve as the basis for downsizing, is persistently avoided. Instead, in 2016, employment in this enterprise was decreased by voluntary and non-selective retirement of workers who met the retirement conditions (with generous severance payments). The largest individual expenditure of this enterprise, the wage bill, actually increased significantly since 2014 instead of being decreased, as EPS failed to implement the government's decision to decrease the net wages of its workers (unlike other public enterprises). For years, EPS's investments have been insufficient, significantly lower than depreciation and in addition, the enterprise's debt doubled since 2009. The greatest improvement in EPS's performance occurred with regards to the low price of electricity for households, which was increased three times since 2015, by a total of 11% (the remaining share of the increase in electricity price, amounting to 7.5%, went into the budget as excise tax). Even with the main problems of EPS being known for a long time (surplus staff, non-profitable entities, low investments, technical losses, low tariffs etc.), the Fiscal Strategy provides no concrete plan or deadlines for their resolution. Instead, the plan for future reform provided in the Fiscal Strategy mostly boils down to an organisational transformation of the enterprise and professional management (which has been planned since the Strategy for 2015 with forecast to 2017).

The reform and transformation of the Tax Administration office is also not planned credibly enough. The Tax Administration is one of the key fiscal institutions which has an impact not only on the collection of public revenues but on the quality of business environment as well. Unfortunately, for more than a decade now, a fundamental socio-political support for building a modern, professional and powerful Tax Administration does not exist. This can be illustrated by the fact that the number of employees fell from around 8.500 in 2003 to 5.500 today, while at the same time the Tax administration has been burdened with many non-core duties such as administering the VAT rebate on baby equipment. Although these issues have been appropriately recognized in the government Tax Administration reform program for 2015-2020., its implementation has been lagging. The Fiscal strategy only generally and in one paragraph states the plan for the adoption of the Action plan for the implementation of the TA reform, mostly on the basis of already known problems but without stating any concrete measures and deadlines for its realization. Therefore, there exists a significant risk that the TA reform will be postponed in the following period as was the case in the previous years, which in turn would have adverse effects on further suppressing the grey economy; and it will make it impossible to improve the quality of the business environment, above all for SMEs whose stronger development represents one the key prerequisite for speeding up economic growth in Serbia.

There are no concrete plans or deadlines for the completion of privatization of state-owned enterprises (from the portfolio of the former Privatization Agency). The issue of 150, mostly loss-making, state-owned enterprises undergoing privatisation, which still employ about 50,000 people, is also not properly addressed. Even though RTB Bor and

Petrohemija are not making losses at this time, this is a consequence of market circumstances (prices) and not their reforms. The Fiscal Council thus believes that they need to be privatized even in 2018, as market circumstance can easily change, which would turn these enterprises back into major loss-makers. Major investments would be necessary for long-term sustainability of operation of RTB Bor and Petrohemija, which these enterprises (and the government) cannot - and should not - fund. At that, in 2018, the destiny of Azotara needs to be resolved as well, as its large losses are now having a strong impact on the balance sheets of Srbijagas (Azotara failed to pay for the gas delivered in 2017, as well). The Fiscal Strategy does not recognize the Government's strong commitment to resolving the issue of enterprises undergoing privatisation permanently even in medium term (by 2020); another bad sign is the fact that the 2018 budget plans for severance payments for employees in these enterprises in the amount of a mere 2 bn dinars (Transition Fund), which suffices for the payment of severance payments for only 3,000 employees. We believe that the Government's hesitation to face these issues head on is unjustified, i.e. that 20 years from the beginning of privatisation is quite a sufficient time period to finally determine whether these enterprises have a market perspective and interested investors, or should be allowed to proceed to bankruptcy.

Local governments have major financial issues that have not been recognized in the Fiscal Strategy. Budgets of many towns and municipalities are disordered, with major delays in payment of liabilities (arrears). At that, the expenditure structure of the major share of local governments is quite poor - large subsidies are given to cover the losses of local public enterprises and insufficient funds are being used for investments. Thus Belgrade, with relatively stable finances, is financing an inefficient city transportation system from the city budget with about 100 million Euros, instead of putting these funds to more efficient use by investing them. Systemic issues of local government budgets and lack of investments have lead Serbia to the very bottom of the European ranking lists in terms of waste treatment, access to clean drinking water, percentage of children enrolled in pre-schools and numerous other indicators. The system of funding local governments, after numerous amendments to the Law adopted in 2011, is quite disordered with extreme imbalances between various cities and municipalities, which will only be made worse with the latest amendments to the Law on Income Tax which leaves the local governments without an additional 5 bn dinars in revenues, in an unsystematic manner. The Fiscal Strategy, however, makes no mention of the issues faced by local governments, there are no indications that monitoring public finances of cities and municipalities will be improved (e.g. by recording and monitoring arrears).

For years, there has been no adherence to the Budget Calendar, which is something that has to change from 2018. Insufficient quality of planning major medium term strategic goals, as well as the time when the Fiscal Strategy was submitted to us, point out that it has, for the large part, been derived from the Law on Budget for 2018, instead of having it the other way around - first clearly defining the objectives of improving public finances in medium term, then planning the annual budget in line with these objectives. This is something that warrants a certain leniency, just for this year, since the period in which Serbia had to manage its finances through a "crisis management" approach is now coming to an end - with numerous temporary items on the budget (that are still not being repealed) and other measures that were frequently adopted ad hoc and with uncertain outcomes. All this made reliable medium-term fiscal forecasts and timely preparation of the Fiscal Strategy difficult. However, from 2018, the budget will be "sailing calmer seas" and there are no new measures of fiscal consolidation, so the Government's focus, in terms of public finance management, would have to turn back to strategic, medium-term goals, which would have to be defined in the Fiscal Strategy. This is why we expect that in 2018 and years to come, the budget calendar will be adhered to, i.e. that a draft of the Fiscal Strategy for 2019 with forecasts for 2020 and 2021 will be submitted to the Fiscal Council for consideration by April 30, 2018, as prescribed by the Law on the Budget System.