Republic of Serbia
FISCAL COUNCIL

FISCAL TRENDS IN 2017 AND RECOMMENDATIONS FOR 2018

Summary

In the following year, it is possible to lay foundations for permanently sustainable and healthy public finances and for the acceleration of economic growth. In 2017, the most important quantitative objectives of fiscal consolidation have been achieved. For the first time since 2005, there will be a fiscal surplus and, after ten years, the public debt shall once again see a significant drop. The balance between fiscal trends has neutralized the immediate danger of a public debt crisis and contributed to macroeconomic stabilization – low inflation and moderate current account deficit. However, the reform objectives of the fiscal consolidation are not even close to be fulfilled. These objectives relate, first of all, to the performance of public and state-owned enterprises, as well as to bringing the system of salaries and employment in the public sector to order, furthermore to a reform of healthcare and education and to the improvement of the business climate (rule of law, efficiency of administration etc). The unreformed public sector still represents an enormous fiscal risk and the most recent warning came in the form of a major budget expenditure for the court cases lost due to irresponsible operation of the state enterprises undergoing restructuring. In addition, the budget structure is still very poor – Serbia holds the negative record in Central and Eastern Europe (CEE) in low expenditures on public investments, so the quality of infrastructure in the country is extremely poor. The unreformed public sector and low public investments are among the most important reasons why Serbia's economic growth is systematically lagging behind that of other CEE countries. In the last three years alone, the GDP in Serbia has accumulated about a 10 pp gap (cumulatively) behind the other countries in the region. However, favourable fiscal trends in 2017, create the conditions needed to change this, by beginning the work on permanent regulation of public finances in Serbia. This is a rare opportunity that should not be missed.

Growth of pensions and salaries in the public sector in 2018 is economically justified, but should not be higher than 5% on average. Favourable fiscal results of 2017 allow for an economically sustainable increase of pensions and salaries in the public sector in the upcoming year. In other words, the salary and pension cut of 2015 has achieved its purpose – the crises that was looming has been avoided and now it is possible to make the first step towards permanently ordered public finances. In order to take that step, we *first* need to define just how economically justifiable it is to increase the salary and wage bill in 2018. The analysis of the Fiscal Council shows that the fiscal space in 2018 allows them to be increased by 5%. A higher increase would not be justifiable in terms of GDP growth, i.e. it would not be a "well-earned" consequence of the increase in private sector production and would reopen dangerous macroeconomic imbalances. *The second* question is: what would be the justified manner to distribute the available funds for the salary and pension increase? The

Fiscal Council strongly supports the position that they should be used for a gradual repeal of the temporary salary and pension cut from 2015, instead of their *ad hoc* increase without objective criteria, as has been announced.

- In 2015, the pensions were decreased progressively, which meant that the burden of fiscal adjustment was borne only by those pensioners who had above-average pensions. This model could have a temporary justification in the protection of the socially most vulnerable pensioners, but in the longer term, it is economically (and perhaps also legally) unjustified, as it disrupts the balance between the amount paid in contributions and the level of the pension. For example, a first step in the permanent restoration of an ordered pension system could be to increase all pensions by 2.5% in 2018 and then to use the remaining fiscal space to annul one half of the temporary cut to the above-average pensions from 2015.
- When it comes to salaries, the situation is somewhat more complex, as the government has failed, for three years, to determine objective criteria for the level of salaries in different parts of the public sector. Instead, at the first mention of a possible salary increase, the public is discussing the magnitude of this increase in individual ministries. However, it should be kept in mind that an increase of 10% in some ministries would mean a salary freeze in others, as the fiscal space for the salary increase is limited. The Fiscal Council would support, in general, a non-linear salary increase in the public sector provided it was backed by professionally elaborated analyses, medium-term plans and objectives. However, the present *ad hoc* approach, with no objective arguments, just adds to the disorder of this system. Instead, we propose, as an economically superior solution, to annul one half of the temporary salary cut from 2015 for all employees in the public sector (increase of the present salaries by 5%). Only in specific cases, where there are obvious disparities that can be proven, a minimal discrepancy from these 5% could be allowed (e.g. a somewhat larger increase in healthcare, which is losing its most educated personel). The Fiscal Council expects the government to set objective framework for the proportions between salaries in the public sector (surgeon, policeman, teacher in primary education etc) and only then, starting from 2019, to begin with the nonlinear salary increase in a transparent and predictable manner.

The Fiscal Council estimates that a budget surplus of about 20 bn dinars will be achieved in 2017. Fiscal trends from 2017 show a significantly stronger increase of public revenues and a somewhat smaller execution of public expenditures compared to the plan. These trends indicate that in 2017, instead of a general government deficit of 75 bn dinars (1.7% of GDP), a fiscal surplus shall be achieved which we estimate, at this time, at about 20 bn dinars (0.5% of GDP). This improvement of the fiscal result, worth as much as 95 bn dinars (2.2% of GDP), is primarily due to public revenues that shall exceed the plan by about 80 bn dinars, while we currently estimate that the public expenditures in 2017 will be about 15 bn dinars lower than planned.

Behind the improvements of the fiscal result in 2017 are some permanent trends with long-term sustainability, but also some temporary factors. As has become habitual in the last three years and in 2017 as well , the improvement of the overall fiscal result was partly influenced by unplanned *temporary* factors. This is how we deem the payment of 9.6 bn dinars from the NBS's profits into the budget, as well as one part of the collected corporate income tax, which was extraordinarily high (about 15 bn dinars) in 2017; in addition, the practice of inefficient realisation of public investments continued, which again is a one-off decrease of the deficit. Furthermore, the temporary salary cut in public enterprises also had an impact on the decrease of deficit (and achievement of the surplus), from which the government collected about 15 bn dinars in non-tax revenues. On the other hand, the *permanent* deficit decrease in 2017 is a consequence of macroeconomic trends with more favourable fiscal effects – higher growth of employment than expected (2.5% instead of 1%), higher inflation (3% instead of the planned 2.4%) and relatively strong appreciation of the Dinar (real appreciation compared to Euro is 5%, instead of a realistically unchanged exchange rate). This lead to an increase in public revenues from contributions, salary tax and VAT (a total of 25 bn dinars), while a stronger dinar meant a decrease in interests expenditures (which are most often paid in foreign currency) by about 10 bn dinars. In addition, the pension reform reduced the number of new pensioners to a greater extent than was expected (increase of the retirement age requirement for women), which, as a consequence, lead to permanently lower expenditures on pensions.

If the temporary factors were to be excluded, the government would have a permanent deficit of 0.5 to 1% of GDP in 2017, which is a good fiscal result offering long-term sustainability. The estimated fiscal surplus of 20 bn dinars is not a good indicator of fiscal trends because of the aforementioned one-off factors, but also, it could still change by the end of the year. For example, the surplus could end up being lower, as some unplanned one-off payments of bonuses to pensioners are being announced for the autumn, and it is also possible that the government will, once again, pay for some left-over debt of public and state-owned enterprises (as it did in the previous years for JAT, Srbijagas, Petrohemija etc). On the other hand, the surplus could easily exceed 20 bn dinars if the implementation of public investments stays at such a low level, or if one of the public enterprises pays additional unplanned funds into the budget. The Fiscal Council has emphasized the issues with the budgeting process in Serbia several times already – with significant adjustments made during the year to adapt to extraordinary and unplanned revenues and expenditures, which blurs the actual fiscal trends. This is why, to ensure the best and most stable quantification of the fiscal result in 2017, which will be taken over into 2018, we have excluded all one-off factors. If these temporary effects were to excluded for 2017, Serbia would no longer have a surplus, but a very good fiscal result would still have been achieved – it would be a minimal fiscal deficit which we estimate at about 0.5 to 1% of GDP.

With the end of 2017, a sufficient improvement of the fiscal balanace has been achieved – no additional austerity measures or measures to increase public revenues are necessary in 2018. In its previous reports and analyses, the Fiscal Council proposed, as a fiscal policy objective offering long-term sustainability, a consolidated government deficit of about 0.5% of GDP. Such a permanent deficit allows for a stable reduction of the share of public debt in the GDP and is completely in line with the EU rules for countries similar to Serbia (countries with an excessive public debt). Since this objective has already been achieved in 2017 (the permanent deficit, excluding one-off factors, is approximately at that level), we estimate that no additional measures for the decrease of the fiscal deficit are needed in 2018 – the priority now should be given to reforms and measures for a permanent regulation and improvement of the structure of public finances of Serbia, which would support, rather than impede, a high economic growth.

Non-reformed public and unprivatized state-owned companies remain the largest fiscal risk. One of the largest fiscal problems that Serbia will keep facing in the upcoming years is poor performance of public and state-owned enterprises. In 2017, insufficient progress has been made towards the resolution of this issue.

- Of the large public enterprises, true reforms are continuing only in Serbian Railways. Srbijagas has achieved a somewhat better performance primarily due to the low prices of gas on the world market (it is now collecting regularly from previously large debtors – heat plants, Petrohemija), but the company is still delivering gas to clients who are not paying and who, despite the low prices of gas, have failed to achieve good results (Azotara, Novi Sad-Gas, Srpska Fabrika Stakla etc). EPS is still avoiding the necessary reforms, so in 2017, a systematization of the necessary jobs in this company has still not been elaborated. Poor management of EPS has led to a strong drop in its production in the first half of the year, significantly lowering the overall economic growth of the entire country.

- In expectation that many non-privatized enterprises will manage to get privatized and find a strategic partner, their status is not being resolved and the fiscal costs of their continued operation have to be born. Azotara, Novi Sad-Gas and Galenika cover their failed performance by not paying their gas bills, Jumko and PKB are not paying for electricity and Simpo is surviving solely on the state aid it is receiving through the Development Fund. The performance of Petrohemija and RTB Bor has temporarily been problem-free in 2017, due to favourable prices of their products, but these enterprises have no chance of surviving in the positive performance zone without restructuring and major investments. This means that their privatization must not be delayed any further despite their good results in 2017, as these two enterprises will soon re-emerge as fiscal problems.

Expenditures for non-privatized enterprises should be presented in the budget to lower the fiscal risk of their poor performance. So, many state-owned enterprises are still surviving solely thanks to public funds, even though these funds are not directly visible in the budget (funding through the Development Fund, not paying their bills for electricity and gas). Unsuccessful and irresponsible operation of these enterprises thus represents a major fiscal risk as it undermines the performance of national public enterprises and, lately, there has been an increasing number of lawsuits before domestic and international courts due to the failure of state-owned enterprises to pay their obligations to their workers and their commercial creditors. The Fiscal Council believes that it is a lesser evil to plan for and pay out these funds (needed to keep the state-owned enterprises alive), from the budget in a transparent way, than to undermine the performance of public enterprises and increase future fiscal risks. In addition, we estimate that a direct presentation of the real and major expenditures stemming from the poor performance of these enterprises in the national budget would accelerate the search for final solutions for these enterprises.

In 2017, the public debt has seen a strong decrease, from 74% of GDP to under 68% of GDP, mostly due to appreciation of dinar compared to the US dollar. During 2017, there was a sharp drop in the share of public debt in GDP. One part of this drop certainly came from better fiscal trends and a greater deficit decrease than was planned (actually passing over into a surplus). However, the largest part (about two thirds) of the decrease in public debt in 2017 is owed to appreciation of the dinar compared to the euro and especially of the dinar compared to the dollar. From the beginning of the year, dinar has seen a real appreciation compared to euro by about 5% and as much as 15% compared to the dollar. Since the majority of Serbian public debt is in dollars and euros, the appreciation of dinar compared to these currencies brought about a significant decrease of the share of public debt in GDP, which is achieved in dinars. Although 2017 is an example of a year in which a change in the exchange rate lead to a significant decrease in public debt, these changes cannot be counted on at all times (and they would also be harmful for economic growth). The only permanent economic factor that can ensure a decrease of the excessive share of public debt in the GDP in the long term is a low fiscal deficit. This is why Serbia needs to maintain a nearly balanced budget (fiscal deficit lower than 0.5% of GDP) in the upcoming years.

Even though the fiscal trends in 2017 were fairly good in principle, the economic growth came well under the estimated mark. We estimate the growth of Serbian GDP in

2017 at about 1.5% to 2%. Such a low economic growth cannot fully be explained by a drought and the issues with the production of electricity at the beginning of the year. Unlike Serbia, all other countries of the Central and Eastern Europe (except Macedonia, which is affected by political instability) have seen a strong acceleration of their economic growth in 2017. Average growth in the countries of Central and Eastern Europe in 2017 is estimated at over 4% at the moment, even though the growth rate forecast for these countries at the end of the previous year was 3%. Serbian economic growth has been systematically lagging behind the comparable countries, practically since 2010. The main reason lies in insufficient investments, as Serbia, with its low share of investments in GDP of about 18%, holds a negative record compared to all other CEE countries. For a necessary increase of investments in GDP to about 25%, the government needs to implement the necessary reforms of public enterprises (primarily EPS), resolve the status of a large number of state-owned enterprises incurring enormous losses (e.g. Azotara), strongly increase public investments and begin reform of healthcare and education. At that, for private investments to grow, the business climate needs to be significantly improved (rule of law, decrease in corruption, increase of public administration efficiency etc). Increase of current expenditures (salaries and pensions) cannot have a large and permanent influence on the increase of Serbian economic growth. Namely, Serbia already has a higher share of consumption in the GDP than other comparable countries and it has failed to result in a larger economic growth in Serbia – on the contrary, the economic growth in Serbia has systematically been lower. Stimulating private consumption with the objective of instigating economic growth can only work in large economies, with underutilized and competitive production capacities, which is not true of Serbia. In Serbia, a stronger increase of pensions and salaries in the public sector (above the GDP growth) would primarily reflect on the increase in foreign trade and domestic imbalances (current account deficit and inflation) and not on the acceleration of economic activity.

Although there is no need for further fiscal savings in 2018, the reforms must intensify and work must continue on improving the business climate. In the previous paragraphs, we have provided a short summary of the main fiscal and macroeconomic trends in 2017, which give rise to the recommendations for fiscal policies for 2018. In short, fiscal trends in the narrow sense are very good. Already in 2017, a sustainable fiscal deficit has been achieved (one-off revenues aside) and there is no more need for further austerity measures or measures aimed at increasing public revenues. However, the government has failed completely in terms of structural reforms, so the unreformed public sector, primarily public and state-owned enterprises, still represent a major fiscal risk. Finally, the fact that Serbian economic growth is far lower than that of other comparable countries must be taken into consideration, and a major share of responsibility for such a result lies on the government, which is not setting aside sufficient funds for public investments and has not ensured a good business climate to allow for private sector growth. The decrease of the fiscal deficit from 2017 and the two previous years allows for a shift in priorities of economic policy to reforms, improvement of the business client and improvement of the budget structure – while preserving the achieved results (the low deficit). In the following paragraphs, more concrete Fiscal Council recommendations for 2018 public finance policies are given.

In 2018, the fiscal deficit should be 0.5% of GDP, giving rise to the fiscal space of about 2% of GDP (for an increase in salaries and pensions, public investments and tax relaxation). We propose, as a good target fiscal deficit in 2018, as well as a fiscal result offering long-term sustainability, a general government deficit of 0.5% of GDP. There are several good reasons for this. *Firstly*, this result is sufficient to significantly decrease the share of public debt in GDP in the upcoming years. Serbian public debt is still very high (we estimate it to about 68% at the end of 2017) and despite the strong decrease seen in this year, it needs to continue dropping. A fiscal deficit of 0.5% of GDP would decrease the public debt in 2018 to about 66% of GDP (assuming unchanged exchange rate for the dinar). *Secondly*, a small and stable deficit of 0.5% of GDP ensures macroeconomic stability and thus provides the necessary preconditions for a sustainable economic growth. *Thirdly*, such a result leads to lower expenditures on interests (due to decreasing public debt), freeing up funds for a much-needed increase in public investments. *Fourthly*, a deficit of 0.5% of GDP is in line with the European union rules for countries similar to Serbia (with public debts over 60% of GDP). *Fifthly*, such a deficit does not call for additional savings in 2018, as this objective has already been achieved in 2017. Moreover, with a fiscal deficit of 0.5% of GDP, the already certain decrease in expenditures on interests and payments of guaranteed debts in 2018 shall allow the government to dispose of about 2% of GDP to increase salaries and pensions in the public sector, increase public investment and lower taxes.

The pension and wage bill could increase in 2018 by 5% at most, which would use up approximately a half of the fiscal space. The shares of salaries and pensions in the GDP have come close to their sustainable levels of 11% for pensions and 8% for gross-1 salaries in 2017, but these levels have not yet been reached. As already mentioned, any increase of pensions and salaries in the public sector over the growth of the nominal GDP is not based in reality and would lead to macroeconomic issues and imbalances. Perhaps the best illustration is the fact that in 2017, the salaries in the private sector have increased by about 4.5 to 5%. A greater growth in the public sector (with, by default, higher job security in the public sector compared to the private sector) would mean an unjustified increase in privileges of the employees in the public sector. In addition, the Fiscal Council strongly advocates the position that the fiscal space for the increase of salaries and pensions in 2018 would have to be used as a step towards a permanent regulation of the pension and salary system, instead of being distributed *ad hoc*, without the necessary analyses and medium-term plan. An increase of the pension and wage bill of 5% would use about 1% of GDP out of the 2% of GDP of fiscal space available in 2018.

In 2018, it is necessary (and possible) to increase public investments by over 300 million euros (0.8% of GDP). Annual expenditures of the government for investments have systemically fallen short of the mark, which is one of the greatest structural weaknesses of Serbian public finances. Serbia spends about 1.5 pp of GDP less on public investments than other CEE countries, which is why (according to the data of the World Economic Forum) the quality of infrastructure is 30% lower than in comparable countries. The main roads, Corridors 10 and 11 have not been completed yet and the deadlines for their completion keep getting pushed. Parts of the main railways (Railway Corridor 10) are not electrified and the speed of trains is significantly lower than initially planned (10-60 km/h instead of 100-120 km/h). The poor state of local infrastructure is a special cause for concern (sewers, water supply, waste water treatment). For this reason, the government (both at the local and the central level) would have to strongly increase the expenditures for public investments in the years to come. This is justified from the view point of encouraging economic growth, as well, as public investments represent the highest quality of public expenditures with overwhelmingly the greatest positive impact on GDP growth, compared to all other fiscal measures. Hence, we believe that it is justified and possible to use a major share of the fiscal space, of about 40 bn dinars, for public investments increase.

A share of the budget space of about 0.3% of GDP, i.e. 15 bn dinars, can be used for tax relaxation in 2018. In addition to the measures on the expenditure side of the budget – increase in public investments and pensions and salaries in the public sector, it would be good to use a part of the budget space on adjustments on the revenue side, i.e. for tax rate decrease. Tax relaxation would, together with a growth in public investments, be another measure (arising from the fiscal space) for a more direct encouragement of economic growth. From the economic viewpoint, a budget space of about 15 bn dinars would allow for taxes and contributions to be decreased from 64% to 62% of the average salary. This relaxation of salary taxation could be implemented *progressively* – by increasing the amount of non-taxable income, allowing for a greatest relaxation for the workers with minimal and below-average salaries; *proportionally* – by decreasing the unemployment contributions and healthcare contributions; or through some combination of the two. In addition, if the Government of the Republic of Serbia wishes to stimulate the culture of entrepreneurship as one of the factors for future economic growth, a part of the budget space of 15 bn dinars could be set aside for implementation of targeted tax relaxations for the newly founded (start-up) enterprises.

Tax Administration modernisation is necessary for the preservation of the achieved good fiscal results and their further improvement. The fiscal deficit decrease in 2015 and 2016 was based, to a large extent, on the suppression of grey economy through the measures of the Tax Administration implemented in the field (inspection controls of businesses, stricter control of VAT and excise tax refunds etc.). However, these measures were not accompanied by a reform and permanent re-enforcement of the capacities of the Tax Administration, which is currently burdened with numerous activities outside of its main scope of work (games of chance, VAT refund for baby equipment), the average age of its employees is over 50, it has an insufficient number of field inspectors, poor analytical capacities, outdated organisational structure, poor information system etc. Preliminary assessments of the Fiscal Council indicate that an unchanged level of tax revenue collection was maintained in 2017 compared to the previous years, meaning that the effects of increased field controls on the public revenue collection increase have been exhausted. This means that the tax revenues will stop growing due to grey economy suppression in 2017 (with grey economy still being more prevalent in Serbia than in comparable countries), and it is also possible that the unreformed Tax Administration jeopardizes the good results achieved in the previous years. This is why we believe that Tax Administration modernization should be one of the priorities of economic policy in 2018. A good plan for the transformation of Tax Administration already exists and its implementation, with perhaps some minor operational modifications, should be accelerated.