Republic of Serbia

FISCAL COUNCIL

STRATEGIC RECOMMENDATIONS FOR THE BUDGET AND FISCAL POLICY IN 2020

Summary

In the 2020 Budget there will be a surplus that should be used to decrease taxation for businesses and to increase investments in infrastructure, and not for salaries. The Fiscal Council analysed current fiscal and macroeconomic trends and forecast public revenue and expenditure for 2020. The forecast shows that there will be a surplus of funds (fiscal space) in the budget in the observed year of about 45 bn dinars, which can be used for new economic policies. Funds of almost 400 m Euros are significant, but still insufficient when compared to all objective needs of the country - which is why they should be responsibly steered to where the needs are greatest. Analysis of the largest weaknesses of domestic economy shows that it would be best to use the available funds as an incentive for the lacklustre economic growth, by decreasing taxation for businesses, as well as for the development of basic infrastructure - the poor condition of which has been hindering economic growth, but also negatively affecting the quality of life of the population. The catastrophic state of environmental infrastructure particularly stands out (water supply, sewers, wastewater treatment, landfills etc.) - which not only diminishes the quality of life, but also endangers the health of the Serbian population. However, already in the Amending Budget Draft Law for 2019, the Government has prematurely defined one of the most important economic policies in 2020 and thus used up a third of the available fiscal space - by proposing an exaggerated raise in general government salaries of over 9.5% on average (instead of a 5 - 5.5% increase which would be economically justified).

We recommend that the Government prepares the Budget for next year with a more conservative projection of real GDP growth in 2020, at about 3%. The medium-term trend of economic growth in Serbia is between 3 and 3.5% and it is not realistic to expect that it will accelerate to 4% next year, as forecast in the Draft Fiscal Strategy for 2020. Serbia had an economic growth of over 4% only once in the previous ten years (4.3% growth in 2018), but this was only because agriculture showed a massive growth that year, exceeding 15% (because it was compared to 2017, a year of heavy droughts) - without it, GDP growth would have remained between 3 and 3.5%. What can currently be assumed for the economic trends in 2020 is the following: *Firstly*, records from the first half of 2019 do not show reliable indications for the

acceleration of current growth (3-3.5%) that could lead to a GDP growth of 4% in 2020. *Secondly*, no positive effect of one-off factors on GDP increase, similar to that of 2018, can be expected in 2020. *Thirdly*, in 2019, economic policies of the country did not change significantly; in addition, the important reforms that would have led to greater economic activity in 2020 were not implemented either. *Finally*, the latest data on economic trends in Central and Eastern European (CEE) countries, as well as the entire EU, with which Serbian economy is closely linked, show that their economic growth is slowing down. All of this indicates that the Government's expectation that Serbian GDP growth will accelerate to 4% in 2020 is not credible. On the contrary, Fiscal Council's recommendation is that the Government should plan the economic growth in the next year at the lower limit of Serbian medium-term economic growth trend of 3% in 2020, due to the deceleration of economic growth in Europe and CEE countries.

A sustainable and economically justified increase in pensions and salaries in the public sector in 2020 is 5-5.5% - but the Government intends to increase the salaries almost twice as much. Conservative and adequate economic growth projection for 2020 would mean that the real GDP growth be forecast at about 3%. Since inflation is expected to be in the range of 2 to 2.5% in 2020, it would mean that the nominal GDP growth in 2020 will most probably be around 5-5.5%. This is the extent of the economically justified increase in the largest budget expenditure - pensions and salaries in the general government. When it comes to pensions, adopting an economically justified "Swiss" formula, which was announced to take place until the end of the year, would result in a pension increase exactly in this range - which the Fiscal Council fully supports. However, already the Amending 2019 budget envisages significantly higher increase in general government salaries, above 9.5% on average. Although this increase in salaries is planned in the Amending budget for 2019, it practically pertains to the 2020 budget, as only one increased salary will be paid out this year (in December). Such a large salary increase would be economically unjustified even if the optimistic forecasts of a 4% economic growth were to come true in 2020. It is also surprising that, in its Draft Fiscal Strategy from June 2019, the Government envisaged that the share of the wage bill to GDP in 2020 would remain at the same level as in 2019, i.e. that the general government salaries would have approximately the same growth as the nominal GDP. Only a few months later, it came out with different proposals, disrupting the credibility of the Government's official plans for fiscal policy.

An exaggerated wage increase in the general government undermines one of the pillars of Serbian public finance sustainability. A strong link between the increase in pensions and salaries in the public sector and the economic growth is one of the main principles of a responsible fiscal policy (together with a low deficit and sustainable public debt). This link is recognized in the national legislation as well, as the fiscal rules from the Budget System Law prescribe the cap for the share of the salaries and pensions to GDP. In addition, in the past, the growth in pensions and salaries in the public sector higher than GDP growth had already led Serbia's public finance to the brink of bankruptcy, which was only avoided through painful measures of fiscal consolidation at the end of 2014. Since then, basic principles of responsible fiscal policy have mostly been followed - revenues and expenditures of the general government are balanced, public debt is decreasing towards a sustainable level and pensions are increasing, approximately, in line with economic growth (which will be put in the code - the Law - starting from 2020 - the "Swiss formula"). However, for the second year in a row, the principle that the growth of salaries in general government should be harmonized with the increase in economic activity is being breached. At the beginning of 2019, salaries in the public sector were increased, on average 9%, even though the nominal GDP growth in 2019 will most probably be below 5.5%. A similar scenario is planned for 2020, when the salary increase of about 9.5% (proposed in the Amending budget for 2019) will come to its full effect. This economically unjustified increase in salaries in the general government will not disrupt the budget in 2020 directly. However, experience from the previous episodes when similar increases took place (salaries in 2007 or pensions in 2008), also under similar conditions of relatively stable public finance (low public debt, relatively small deficit) - shows that a disruption in the basic principles of sustainable fiscal policy cannot be implemented in the long run and that such mistakes are paid for in the future, at a much higher price.

Due to the excessive wage increase in the public sector, the decrease of tax burden on businesses will most likely be only a half of what it potentially could be in 2020. The second issue with the exaggerated increase in public sector salaries is the fact that it pushes out the funds needed for other, more efficient measures. As the argument used to justify the excessive wage increase in the general government, we often hear that the government had created a surplus with its responsible administration, meaning that it can now use this surplus to pay for the salary increase to all employees. The first part of this claim is mostly correct, the government did lead a mostly responsible fiscal policy since 2015 and there truly are funds available in the budget - but the second part of the sentence is incorrect. The surplus in the Serbian budget belongs to all citizens of Serbia, not only to the budget beneficiaries; it should be steered to where the country's needs are the most dire - which certainly isn't an increase in salaries in the public sector. In the case of 2020 budget, it can already be seen how excessive salary increase is pushing out the good economic policy measures. The Government has, for example, already announced a decrease in the tax burden on businesses by decreasing the contributions for pension and disability insurance from 26% to 25.5% and increasing the non-taxable salary portion from 15,300 to 16,300 dinars. Fiscal Council's analyses (see chapter V), however, show that this tax cut aimed at businesses could have been double had the money not been unjustifiably routed into an excessive increase in the salaries of general government employees.

Successful fiscal consolidation led to a surplus in the budget that will appear in 2020, which we estimate to be at around 45 bn dinars (0.8 % of GDP). Public finance management always has a certain inertia, i.e. the results of fiscal policies always become visible with a certain delay. Thus, irresponsible public finance management and high deficit can go unpunished for a certain period of time, but they will eventually cause severe problems. It first leads to a strong public debt increase, which in turn decreases available funds in the future, as a sizable share of future budget expenditures must be set aside to repay the cost of the loan, i.e. the appropriate interest. On the other hand, if the budget is approximately balanced (which has been the case in Serbia in the last four years), the share of public debt to GDP is gradually decreased. This means that the government shall be using less and less of its funds for interest payments and, since budget revenues grow due to economic growth, there will be new funds that can be used to support economic policies. We estimate that this surplus shall amount to about 45 bn dinars (see chapter 2) in 2020 and it should be steered towards the largest economic and social issues in the country. Our analysis shows that these priorities are: insufficient economic growth, poor state of the basic infrastructure (roads, railroads and others) and high environmental pollution. Unfortunately, we have already mentioned that an important share of these funds will most probably be spent on an excessive wage increase in the public sector, and there is also a risk that the remaining part of these limited funds will be wasted on projects that do not boost economic growth and do not improve the quality of life of the Serbian population (construction of sports facilities, increased purchase of equipment for the army and the police).

Low GDP growth is Serbia's largest economic problem; therefore, the surplus of funds in 2020 should primarily be directed towards incentives for economic growth. In the last decade, Serbia has been lagging behind comparable Central and Eastern European (CEE) countries in terms of economic growth and (consequentially) in the living standard of the population. Serbian cumulative GDP growth from 2010 to mid-2019 amounted to approximately 19%, while in other CEE countries it was 34% - therefore, the CEE countries have increased their lead in the living standard by the difference between these two values. A similar trend continues in 2019, when Serbia, in the first half of the year, showed a GDP growth of 2.8% and CEE countries on average showed 4% (see chapter 3). Economic and social fundamentals - high corruption, insufficient rule of law, undeveloped institutions, poor education system, low performance of public enterprises, together with their lack of investments etc. are the factors behind Serbian low economic growth in the long term. Therefore, the Government would have to implement reforms that would lead to the improvement of all aforementioned factors in order to achieve a permanent economic growth acceleration, but in the short term, economic growth can and should be accelerated using fiscal incentives. Two tried and proven measures that can accelerate economic growth in the short term are targeted decrease in taxes for businesses and increase in government investments into infrastructure - and all (or at least the remaining part) of the fiscal space in 2020 should be directed at them.

The most efficient tax measure for incentivizing economic growth is the decrease in the fiscal burden on salaries. The majority of tax rates in Serbia are currently lower than Eastern European average; at that, economic arguments do not support a VAT decrease (as it has no impact on improving the competitiveness of the domestic economy) or a decrease in corporate income tax, as there are no indications that their levels represent a significant obstacle to economic growth. Therefore, a decrease in the fiscal burden on salaries is a priority from the economic viewpoint, to improve the competitiveness of the domestic workforce and stimulate employment and investments of businesses. This objective can be achieved either by decreasing the social contributions rate or by increasing the non-taxable salary portion; due to a large (excessive) planned increase in the minimum wage, we recommend the latter option so that the tax cut would be most prominently felt by employers and workers with low wages. Thus, about 20 bn fiscal space would allow for the non-taxable salary portion to be increased from 15,300 to 25,000 dinars in 2020, which would decrease the burden on minimal salaries from 58% to 53%, while the decrease of the tax burden on the average salary would be from 62% to 60%. Since the income tax is dominantly collected by local governments, the national budget would compensate for their loss of tax revenue by increasing the non-earmarked transfers. We note, however, that the proposed excessive wage increase in the general government will, by all indications, significantly decrease this good measure: according to the latest announcements from the Government, the actual tax cut will be only a half of the possible 20 bn dinars.

Higher public investments into infrastructure are necessary not only to accelerate the economic growth, but also due to its exceptionally poor state. Public investments are the most efficient type of government spending, i.e. they have several times larger effect on economic growth acceleration than the increase in current spending (e.g. pensions and salaries in the public sector). This effect on GDP growth comes from the fact that infrastructure development mobilizes mostly domestic construction industry (workers, companies, construction materials etc) which affects GDP growth from the demand side (during the works and immediately after). Development of quality infrastructure is also very important for the acceleration of Serbia's economic growth in the long term (from the supply side) - as quality infrastructure facilitates the operation of the private sector, while higher investments into infrastructure of healthcare and education sector improve the human capital. What is equally important, however, is that Serbia has enormous needs for the development of basic infrastructure. For over a decade, Serbia's spending on public investments has been lower than that of comparable Central and Eastern European countries by a third (about 3% of GDP compared to 4.5% of GDP in CEE, 2005-2018). This is the reason why Serbia still does not have even the basic infrastructure developed. For example, the speed of trains is below 60 km/h on over half of the railways; in addition, other countries in the region have several times better developed motorway networks. Serbia particularly lags behind the comparable countries in terms of communal and other infrastructure in the field of environmental protection: just over a half of the homes are connected to the public sewers network (in CEE, about 85%), less than 10% of the urban wastewater is treated prior to discharge in the water bodies (in CEE, between 60% and 95%), only 80% of the generated communal waste is collected (almost 100% in CEE) - which then ends up without any treatment on landfills that do not meet sanitary conditions (CEE treats about 50%), drinking water in Serbia is not fit for use in almost 40% of the city water supplies etc.

Investments into communal infrastructure and environmental protection must and can be increased by about 130 m Euros (15 bn dinars) in 2020. The Fiscal Council has been pointing out, for a long time, the devastatingly poor condition of the communal infrastructure and environment in Serbia, which requires a strong investment increase in these areas. The opportunity to begin resolving some of the more pressing environmental issues appeared already in 2019 - not only was there fiscal space for this, but our analysis showed that there had been projects already in the pipeline that could have been implemented this year (construction of urban wastewater treatment plants, management of non-engineered municipal landfills etc.) However, the necessary funds for the execution of the proposed investments have not made it into the 2019 Budget, which is why concrete works have not come far. The situation is similar now, as the budget for 2020 is being prepared - as we once again estimate that there is fiscal space for an increase in investments into communal infrastructure and environmental protection of about 130 m Euros (almost 0.3% of the GDP) and a sufficient number of priority projects. In addition to the existing but incompleted projects, in the meantime, technical documentation has been completed for some new projects as well, such as the construction of a regional landfill in Novi Sad, Sombor, Pirot and Priboj. In order to avoid wasting yet another year, we believe that the Government would have to plan for the necessary funds for these investments in the Budget in a transparent manner, in the allocations of the respective institutions. The second precondition for the implementation of the planned projects is for the Government to ensure a good coordination between the numerous institutions that are responsible for them (Ministry of Environmental Protection, Ministry of Construction, Transport and Infrastructure, Office for Public Investment Management, local government bodies etc.) Namely, the diffuse distribution of organisational competencies in the field of environmental protection was one of the main reasons why investments in this field were completely neglected in the previous period.

A little under 100 million Euros remain for the increase in investments into the road and railroad infrastructure in 2020, and it should be spent on priority projects. As we have demonstrated, in the 2020 Budget, a limited fiscal space will appear - and it should be spent on the country's priority needs. However, the Government has already steered quite a sizeable share of these funds into the excessive wage increase; plus, taking into account that a part of the funds should be routed to justified priorities such as a tax cut for the economy and an increase in environmental protection spending, the remaining funds for the increase in investments into road and railroad infrastructure in 2020 amount to less than 100 million Euros. We estimate that these funds are sufficient for an increase in investments into priority projects, but not for all announced projects in the field. The priority projects in the road infrastructure are: Morava Corridor, Corridor 11 (Preljina - Požega section) and ring-road around Belgrade; and in the railway infrastructure: electrification and reconstruction of the Niš - Dimitrovgrad railroad and the Belgrade - Budapest railroad that has already been started. Therefore, already in 2020, the Government will have to make a selection of the projects that can be implemented in that year, due to the limited amount of funds. This selection would have to be even stricter if any additional share of the available fiscal space were to be spent in an economically unproductive way, similar as in 2019 (for example, for weapons for the army and the police).

The Government is announcing a new investment cycle in the upcoming five years, which Serbia does need - but the plan is not yet credible and cannot be supported unconditionally. Lately, there were announcements from the Government that the beginning of a large public investment cycle is planned for 2020; however, the details of this plan are unknown. It could be concluded from the statements of the officials that the investment plan will encompass some justified investments, such as those into transport and communal infrastructure, hospitals and schools, but also some other non-productive investments, such as construction and reconstruction of football stadiums. In order for the Government's plan to be justified and credible, it has to have the following elements: *First*, financing for the planned investments must be defined, and it has to be seen exactly what funds are available for them in the Budget in the first place; *second*, a list of priorities must be made, i.e. a selection of projects in line with the country's objective needs; *third*, efficiency in realisation of the infrastructural projects must be improved, being that even the current level of investments, which is quite low, is not implemented without breaching the deadlines for completion, additional costs - and often with poor quality of the works; *fourth*, a serious government program for a strong public investments increase would have to go through both expert, and general public debate. Without these elements, all unfavourable experiences with the previous National Investment Plan from 2006 could be repeated.

The Fiscal Council estimates that the public investments could, in the medium term, increase to about 5.5% of GDP - which does not provide the space for all the announced projects. The analysis we have conducted in this report shows that, with a responsible fiscal policy (primarily meaning the increase in pensions and salaries in line with GDP growth), the share of public investments to GDP in the medium term could be increased to 5.5% (see chapter 6). This is a relatively strong public investments increase, from their current level which, after the increase in 2018 and 2019, currently amounts to about 4.5 % of GDP - the needs are even greater, but the funds are limited. As an illustration, our analysis shows that a total of 13 bn Euros would have to be allocated for all public investments in the upcoming five years. In contrast, the official plans of the Government (Projects of the Ministry of Construction, Transport and Infrastructure published at the end of 2018) as well as the announcements from other officials imply far larger public investments in the five-year period (of between 15 and 20 bn Euros) - for which, objectively, there just isn't sufficient funds, or operational capacities. It is therefore necessary to make a good selection of the projects based on the country's justified needs. To that end, the Fiscal Council analysed where the largest infrastructural problems in

Serbia are, and has formulated a proposal for priority public investments increase accordingly. These priorities are in the fields of road and railroad infrastructure, environmental protection, education and healthcare. In line with those needs, as well as the available fiscal space, we have also estimated the appropriate funds for the increase in investments in the upcoming five years (Table).

Table: Proposed increase in public investment of the general government in the medium term

	2020	2021	2022	2023	2024
			% GDP		
Total Public Investment	**4.8**	**5.0**	**5.3**	**5.5**	**5.5**
Transport infrastructure	2.4	2.7	3.0	3.0	2.8
Environment and Communal Infrastructure	0.5	0.6	0.7	0.8	0.9
Health and Education	0.3	0.4	0.5	0.6	0.7
Other investment	0.8	0.8	0.8	0.8	0.8
Defence and Police	0.7	0.5	0.3	0.3	0.3
Investment net of Defence and Police	**4.1**	**4.5**	**5.0**	**5.2**	**5.2**
			mil EUR		
Total public investment	2,253	2,462	2,726	2,955	3,087
Transport infrastructure	1,148	1,328	1,543	1,612	1,569
Environment and Communal Infrastructure	217	295	360	430	505
Health and Education	160	197	257	322	393
Other investment	398	394	412	430	449
Defence and Police	330	248	156	163	171
Investment net of Defence and Police	1,923	2,214	2,570	2,792	2,917

Source: Fiscal Council calculations
Note: Methodology based on OECD's Classification of the Functions of Government (COFOG)