Republic of Serbia
FISCAL COUNCIL

PUBLIC INVESTMENTS IN SERBIA: SUPPORTING GROWTH IN FISCAL CONSOLIDATION

Summary

The increase in public investments is currently the best available measure of antirecessionary policy. Inefficient execution of public investments is one of the critical deficiencies of public finances, but of the overall economic policy in Serbia, as well. The forthcoming fiscal consolidation shall be carried out in an adverse recessionary environment, whilst the increase in public investments is a rare economic policy which can support growth. Therefore, it must not be permitted that in 2015 Serbia once again underperforms in executing public investments, as was the case in 2013 and 2014. Instead, the level of public investments should, as early as 2015, be increased even above the current plans – to approximately 3.5% of the GDP, instead of the currently planned 3% of the GDP – even at the cost of a slightly higher fiscal deficit. A credible plan of increasing public investments to 4-5% of the GDP should be elaborated for the next three-year period, which is an appropriate level for the current development of Serbia. Fiscal Council's analysis shows that the adequate financial resources for that purpose are in place, as well as unquestionable projects, the implementation of which would significantly improve the quality of infrastructure in the country and prevent Serbia's entering a prolonged recession.

Fiscal consolidation shall additionally aggravate the recession Serbia's economy has been in since the beginning of 2014; the increase in public investments is one of the rare economic policies which can significantly help. In order to avoid the public debt crisis, Serbia needs fiscal consolidation which would decrease budget deficit from the current level of 6.6% of the GDP to below 3% of the GDP. A problem which might jeopardize successful implementation of fiscal consolidation is the recession Serbia's economy was in during 2014 and which will carry on to at least 2015. It is therefore important to activate anti-recession measures along with the austerity measures – and the best of all anti-recession measures the state has at its disposal is the increase in the scope and efficiency of public investments. Fiscal adjustment implying a decrease in the current and increase in the capital budget expenditures is also recommended by the IMF[1] - because of which such approach would have to be accepted within a new Serbia-IMF arrangement.

A positive effect the increase in the government's capital expenditures has on the economy may compensate recession strains due to a significantly higher decrease in the

[1] IMF, October 2014, *WEO Chapter 3: Is It Time for an Infrastructure Push? The Macroeconomic Effects of Public Investment*

current spending. Fiscal multiplier of public investments is higher than the current public spending multiplier and it is estimated that this ratio could be approximately 1:3 for Serbia. This means that a positive effect to the economic growth of the increase in public investments by 1 p.p. of the GDP might compensate negative effect of the public spending decrease by approximately 3 p.p. of the GDP. Therefore, the proposed increase in public investments to 3.5% of the GDP in 2015 could definitely alleviate, if not fully compensate the temporary effect of the government's savings to the economic activity slowdown. Besides a short-term effect on economy measured by the fiscal multipliers, public investments also have a long-term positive effect on economic growth, for they increase the quality of infrastructure used by the private sector.

The additional increase in public investments in 2015 is acceptable even at the cost of a fiscal deficit slightly exceeding the plan. Ideally, the room for proposed increase in public investments to 3.5% of the GDP (instead of 3% of the GDP as planned by the budget) should be provided for within the envisaged fiscal deficit framework. Consequently, this would mean that some other, less productive public expenditures – eg. subsidies, should be decreased more severely. More detailed analyses by the Fiscal Council, however, evidence that even in case it is not possible to achieve sufficient savings in other public expenditure items, a more substantial increase in public investments – even at the cost of a certain government deficit increase, should still be planned.

A profound and prolonged recession could easily jeopardize fiscal consolidation implementation, while a slight and controlled deficit increase (eg. to 6.1% of the GDP instead of the currently planned 5.9% of the GDP) would not be so precarious, on condition that the only reason for that be the increase in public investments.

The increase in public investments in Serbia is also necessary because the current state of the infrastructure is extremely destitute. The alarming state of infrastructure in Serbia is indicated by the international researches in the area of competitiveness. According to the latest published Global Competitiveness Report of the World Economic Forum for the period 2014/2015[2], Serbia is among the worst rated countries judging by the state of the infrastructure. This is a consequence of a very low degree of development of the road, railroad and port transportation network. According to most competitiveness and infrastructure quality indicators, Serbia is ranked much lower than the one hundredth position and lower than other countries in the region.

The allocations for public investments in Serbia are much lower than in other comparable countries – within a medium-term period they should be increased to 4-5% of the GDP. The share of public investments in the GDP for countries at Serbia's development level should amount to 4-5%, although in the phases of faster development and construction of infrastructure (Serbia's needs), this ratio increases to a significantly higher level. In any case, the current investment level of 2-3% of the GDP is below any acceptable criterion; such level definitely does not lay the foundations for the growth and development of the private sector. Even worse, the investments in Serbia show a declining trend. In 2007 they were at an acceptable level of 4.8% of the GDP, between 2009 and 2012 they were low, at an average and stable level of approximately 3.5% of the GDP, while in 2013 and 2014 they additionally plummeted to the lowest level in history of 2.2% and 2.5% of the GDP. The Fiscal Council has therefore investigated as to what was the cause of such a decline in public investments and what could be changed so as to have them increased to the satisfactory level in the next years.

[2] *The Global Competitiveness Report 2014-2015, World Economic Forum*.

The financial limitations are not a cause to such a low execution of public investments. A large amount of financial funds have been designated to Serbia by the International Financial Institutions, on generally favorable conditions – however, their use is not timely resulting in significant undrawn funds. According to the Fiscal Council's analysis, the amount of loans approved for the current infrastructure projects amounts to cca €5 billion, as much as €3.7 billion out of which remain available. Most available funds are in the road infrastructure sector, amounting to €1.6 billion, while the share of railroads and energy sector amounts to €1.55 billion. The funds available for other infrastructure projects amount to some €530 million.

There is also a sufficient number of priority projects in Serbia the implementation of which would significantly improve country's infrastructure. The exceptionally low allocations for public investments might be a consequence of the shortage of adequate priority infrastructure projects. Because of that, the Fiscal Council investigated into whether there is a discrepancy between large approved investment loans and actual government needs. To that aim, we have compared the data on the biggest deficiencies of infrastructure in Serbia which indicates priority needs for investing with the purpose of the funds allocated for public investments. The analysis has shown that the largest approved, yet not withdrawn funds, have been allocated for the very unquestionable government priorities, with the biggest effect on the improvement of infrastructure quality and economic growth. Completion of these priorities would also significantly upgrade Serbia's ranking in the competitiveness rating tables, while their undisputable significance is also indicated by the fact that some of them, like the construction of the road and railroad Corridor 10, are a part of European strategic plans as well. Therefore, the lack of priority projects is also not a reason for an unacceptably low level of public investments in Serbia.

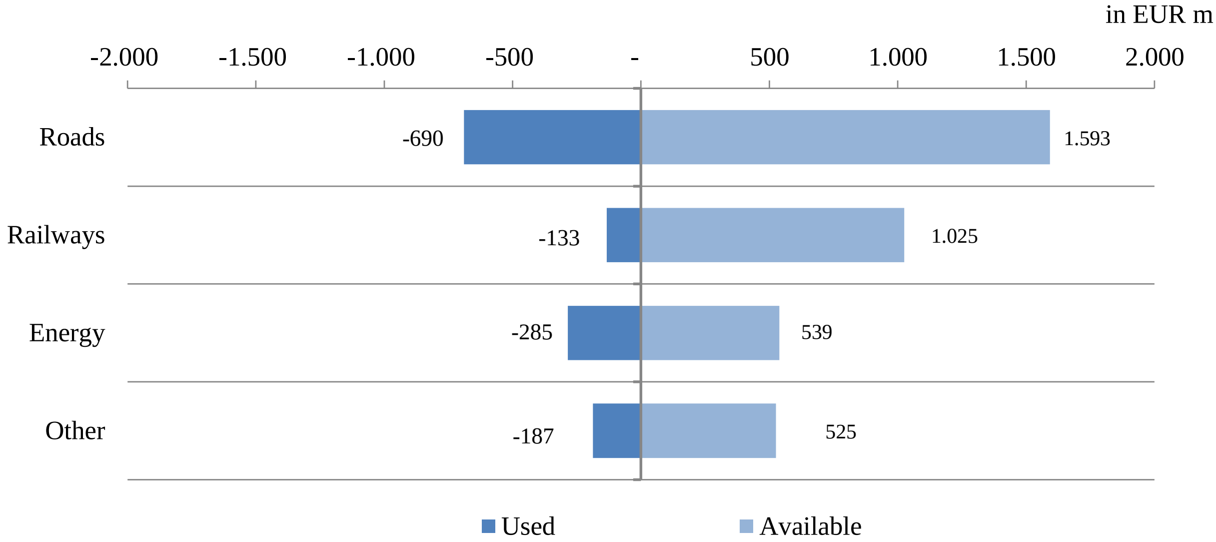
A table of available funds for current infrastructure projects, per areas and creditors

in EUR m

Area	Creditor	Approved amount	Used	Available
Roads	EIB	869	170,8	698,2
	EBRD	330	110,3	219,7
	World Bank	355	97,5	257,5
	Azerbaijan	300	153	147
	EXIM	429	158	271
Railways	EIB	80	66,2	13,8
	EBRD	295	54,2	240,9
	Kuwait	25,8	0	25,8
	Russia	758	13	745
Energy	EIB	64,5	22,4	42,1
	EBRD	302,5	70,8	231,7
	World Bank	21	8	13
	EXIM	231	135	96
	KfW	205	48	157
Other	EIB	515	158,9	356,1
	World Bank	60	0,0	60
	KfW	138	28	110
		4.979	**1.295**	**3.684**

Source: Analysis by the Fiscal Council

A review of withdrawn and available funds for the current infrastructure projects per areas

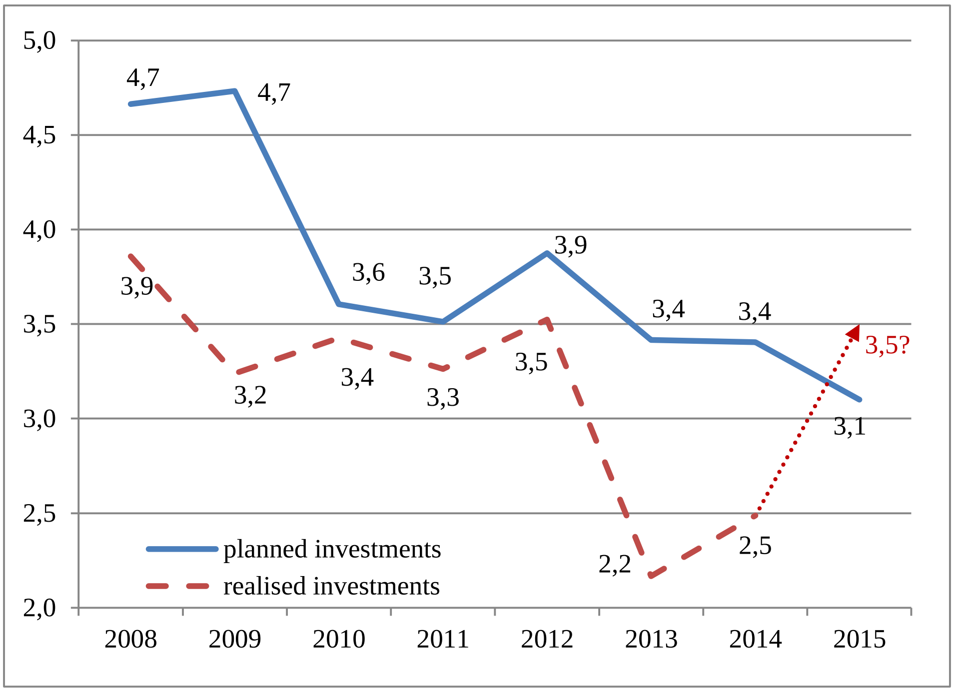


If the planned infrastructure projects were implemented on time, Fiscal Council's suggestion on the increase in public investments to 3.5% of the GDP in 2015 (and to over 4% of the GDP in 2016) would automatically be realized. The implementation of a big number of projects does not start as planned, which, along with inefficiency (tardiness) in carrying out the works that have already started, results in a big number of delayed projects.

This delay is highly costly for the government, not only because of insufficient investment in infrastructure, but also because of the fact that the penalties for due but not withdrawn funds have been paid to international creditors for quite a number of projects. Because of delays in withdrawing funds approved, Serbia pays annual penalties in the amount of approximately €4 million, while it is estimated that the withdrawal of approximately €1 billion is in delay. Should in 2015 the infrastructure projects, for which the financing has already been approved, be implemented within the planned deadlines, an automatic increase in public investments to 3.5% of the GDP (as suggested by the Fiscal Council) would be achieved. Therefore, no new projects or extraordinary efforts exerted to carry out the works "before the deadline" are necessary – it only takes observing the planned timelines for the implementation of the current projects.

The annual budget plans for public investments are, however, never accomplished, which would prove to be very dangerous if continued in the years ahead. While all other public expenditures were in the previous years mostly executed in line with the budget plan set at the beginning of the year (frequently even exceeding the plan), a specific characteristic of public investments is that their execution has always been below the planned level. In extreme cases (2009, 2013 and 2014) the execution of public investments was by 30 to 40% lower than envisaged by the budget plan set at the beginning of the year. If similar trends in the execution of the planned public investments remained in 2015 as well, the suggestion of the Fiscal Council to increase public investments to 3.5% of the GDP would be just a "dead letter". We therefore opine that in the years ahead not only the planned levels of allocations for public investments, but also the implementation of such plans, should be increased.

Planned and executed public investments (2008-2015)



The analysis of the Fiscal Council indicates that an extreme inefficiency of the government in the implementation of public investments is a fundamental reason for the low level of their execution. A severe inefficiency of the government is the answer to one of the key issues of our research, which is: why are the investments in Serbia at such a low level, given that they are economically justified, there is a plethora of initiated and planned infrastructure projects with funds provided for their implementation and the needs of the government for infrastructure improvement are enormous? The majority of individual projects we analyzed was, however, implemented with numerous problems: from inadequate project documentation, difficulties encountered in land expropriation, poor control of the contractors which led to not only exceeding the agreed deadlines, but to the increase in the price of works, slow issuing of licences, etc., as well. There were failures at all levels and at all stages of implementation. From the level of a line ministry, through the state-owned companies in charge of organizing the execution of infrastructure works, designers, to the contractors' companies – there was inappropriate, unprofessional and unreliable behaviour and absence of responsibility for obligations assumed. Additionally, it is obvious there is no effective monitoring of investment execution in the course of the year that could provide early warning signals on problems in project execution.

The increase in the efficiency of public investment execution implies resolving of a large number of various and complex problems. We emphasize the following out of quite a number of recommendations for improving public investment managing: 1) at the strategic level – the changes in the infrastructure construction priorities along with the changes of political cycles, and often even within the mandate of one and the same Government, must not be allowed. New projects have constantly been publicly proposed, while the old ones still have not been completed, sometimes not even launched. Serbia has adopted numerous strategies for infrastructure development as well as clear directions for long- and short-term activities, which is the only correct and sustainable mode of channeling public investments and project prioritization; 2) from the analytical point of view – the government must upgrade its analytical capacities and conduct detailed and credible profitability analyses prior to engaging in any infrastructure project. It is not acceptable that the decisions on investing be made based on the expressed interest of a creditor to finance them solely, without a government having prior to that a clear picture of the benefits and costs of such a project, as well as of the optimum model for the project implementation; 3) from the operational point of view – a hierarchical responsibility for the execution of each and every individual investment must be established. The minister in charge should make a commitment at the beginning of the year regarding the implementation of specific projects (eg. a section of the Corridor 10) to be completed in the course of the year and should be held fully responsible for the implementation of assumed obligations; 4) transparency – the fulfillment of set objectives should be monitored periodically (monthly) through a standardized and publicly accessible reporting system which should primarily enable timely identifying and eliminating all possible deadlocks; 5) from the organizational point of view – in practice there are various organizational models which in certain countries have contributed to a more efficient execution of public investments. There are countries that are successful in managing public investments just through coordination of relevant ministries and government bodies, there are others that have specialized investments units within their ministries, and there are those who have centralized their investment management (to the level of Prime Minister office, for example). Therefore, Fiscal Council believes that the Government is best positioned to determine which model is the most suitable for managing public investments in Serbia. Regardless of the chosen model, significantly larger efforts and resources will have to be dedicated to managing public investments relative to what was the practice in the past.