Republic of Serbia
Fiscal Council

SUMMARY OF THE REPORT "ASSESSMENT OF 2013 BUDGET REBALANCE, STRUCTURAL REFORMS PROPOSAL AND FUTURE FISCAL TRENDS"

Sharp reduction of the fiscal deficit and blocking public debt growth are the most important tasks of the economic policy, since, otherwise, the crisis is inevitable. Public finances in Serbia are still on an unsustainable path. The latest response of the Government to the unfavourable fiscal trends includes three groups of measures: 1) Republic budget rebalance – which would provide for certain savings by the end of 2013, 2) limitation of growth of public sector pensions and wages in the following one year and a half – for deficit reduction in 2014 and 3) structural reforms – so as to make savings in the medium run and attain permanent recovery of public finances. The Fiscal Council strongly supports the announced launch of structural reforms and this is what we estimate as the most valuable part of the Government program. However, the list of proposed reforms should include the pension reform which was unjustifiably omitted. The rebalance which reduces the budget expenditure was indispensable, but the Fiscal Council is somewhat sceptical about estimating its content. Limitation of pensions and wages indexation by the end of the following year is a fiscally responsible measure, but it will not be sufficient to reach the necessary deficit reduction in 2014. In line with the Government measures, this Fiscal Council's report includes three different large sections: the first one includes the estimate of proposed structural reforms, the second one presents the budget rebalance assessment and the third one the potential fiscal trends forecast for 2014 and in the medium run.

The Fiscal Council fully supports the Government's decision to initiate some of the most important structural reforms. The Government made a plan for the completion of restructuring process in the socially-owned companies and announced a reversal in the management policy in public enterprises. Although the Fiscal Strategy of November 2012 has already presented a general plan for solving the problem of enterprises undergoing restructuring, only the latest proposal makes a substantial progress. The plan is now elaborated, there are precisely defined deadlines for settling different cases and, for the first time, there are funds planned and included in the budget for its implementation. The reform of some public (and state-owned) enterprises was announced with slightly fewer details (Srbijagas, JAT, Galenika, Dunav osiguranje, Železnice Srbije and Resavica). The reforms related to public and socially-owned companies undergoing restructuring are not only necessary from the fiscal consolidation standpoint, but they would also increase the efficiency of the local economy to a great extent, improve the business environment and accelerate the economic growth. Therefore, they must not be abandoned. The Fiscal Council also encourages other announced reform targets of the Government which relate to the improvement in tax income collection, reduction of the number of employees in the public administration and labour market reform. However, we are aware of the fact that not all necessary conditions for the realisation of these objectives such as the preparation of detailed sector plans for staff reduction, agreements with trade unions, solving numerous technical issues, etc. have been met and therefore, we support the Government's intention to complete these processes as soon as possible.

Adopting the budget rebalance as early as in the middle of the year is the right decision, but we think that the Republic deficit will amount to around RSD 200 billion instead of the RSD 178 billion as it is planned in the budget rebalance. In the first five months of 2013, the Republic budget deficit amounted to RSD 93.6 billion and it became obvious that, without the Government's reaction, by the end of the year, it could be almost twice as big as the RSD 122 billion optimistically planned in the former Budget Law. Under these circumstances, the Government decided to propose the budget rebalance as early as in mid 2013, thus planning to reduce some expenditure and thereby limiting the Republic deficit to RSD 178 billion, which is a good policy in general. Still, the Fiscal Council believes that the rebalance is not completely adequate, since the budget revenues projections are optimistic and it is most likely that not every savings measure will be implemented. Therefore, we estimate that the Republic budget deficit in 2013 could record about RSD 200 billion in comparison to the planned RSD 178 billion. On the state level, instead of the planned 5.2% of GDP, the deficit could amount to approximately 6% of GDP and this high deficit would mark the beginning of 2014.

The Government still does not have a program for a substantial deficit decrease in 2014. The only substantial savings measure planned for 2014 is the relatively low wages and pensions indexation of 0.5 % planned in October 2013, 0.5% in April 2014 and 1.5% in October 2014. Such an indexation will make savings in the budget of around 1% of GDP, but it will still not be sufficient for a more considerable deficit reduction in 2014. One of the reasons for this is that almost half of these savings will be spent immediately for increased expenditures arising from public debt interest rates. Namely, a sharp public debt growth results in a high growth of interest rates expenditure. In the past five years, budget allocations used so as to cover the interest rates grew by approximately 0.4% of GPD per year and a similar growth is expected in 2014 as well. Nevertheless, there is a risk the growth could be even higher since the general lending conditions in the world market are deteriorating, while the interest rates for Serbian borrowing in the last month have been growing even faster than in other countries. For this reason, it is necessary to adopt new, sharp savings measures by the end of the year, since, otherwise, 2014 fiscal deficit will not be decreased to the adequate level (Fiscal Council's assesses that the public finances sustainability requires deficit reduction in 2014 of over 2% of GDP in comparison to the 2013 level). The Fiscal Council proposes introduction of temporary solidarity tax to public sector wages and pensions which are above average as the most important additional measure. Thereby, the biggest share of necessary adjustments would be borne by those with the highest income.

Economic growth requires fiscal consolidation, but the fiscal consolidation alone is not enough. Successful fiscal consolidation is of key importance for economic growth, since, otherwise, one can expect public debt crises, high inflation and other consequences which may push the state into deep recession (the most recent examples are the crises in Greece and Portugal). Still, fiscal consolidation is only one segment of broad measures which lead to the economic growth. Therefore, in addition to fiscal deficit reduction and blocking public debt growth, the Government has to implement additional reforms aimed at fostering business environment. A part of these reforms has already been proposed by the Program of measures for public sector reform and it relates to the reform of state-owned and public enterprises, labour market reform and shortening procedures for the issuance of construction permits. Other sectors which affect the economic environment to a great extent such as regulatory guillotine, protection of market competition, increase in legal system efficiency, etc. should be also included in the list.

The Government proposed a good program for the completion of restructuring process in socially-owned enterprises. Although direct subsidies for these enterprises are not high, in fact, they present the cost to the state of at least € 750 million annually; with the exception of direct subsidies which are provided from the budget, those companies neither settle their liabilities towards the state, electricity bills, public utility services nor do they settle all the liabilities towards companies. The problem which has postponed deciding the fate of these enterprises for more than ten years lies in the fact that the given indirect expenditures have never been treated as the real ones and that there is a great number of employees in these enterprises (around 60,000) and most of them will lose their jobs. Although the Fiscal Council supports the current Government plan, we would like to stress that there are also certain risks that not everything that has been planned will be realised. The highest risk lies in the fact that the key challenges are postponed for 2014 when the restructuring of great systems (IMR, 14. Oktobar, Prva petoletka, etc.) is planned.

The Government announces huge changes in the operations of public enterprises operating at a loss, but those announcements have not been elaborated. The biggest losses in all public and state-owned enterprises are recorded in Srbijagas and these losses in 2012 amounted to around RSD 35 billion. Along with all this, the state has guaranteed the borrowing in this company for current solvency amounting to around € 800 million and the state is now obliged to assume the liabilities of the company. Although we cannot judge from the documents on the public enterprises reform plan which were submitted to us how this company will operate without losses in the future, we encourage the announcement of the Government to finally suspend expensive borrowing of insolvent Srbijagas. We declare similar support to the planned reduction of direct subsidies for Železnice Srbije and the mine Resavica as well, although we would have been more convinced that the announced savings would be made if we would have been informed on how the funds missing in these companies would be compensated. In the end, we think that the restructuring and privatisation of Galenika and Dunav osiguranje is justified, and that the potential strategic partnership with Etihad in JAT company is an opportunity which should be used by all means.

The announced reforms also include the rationalisation of the number of employees in the public sector. There are relevant analyses which indicate extra staff in the public sector and the Fiscal Council has pointed that out several times. However, the reduction of the number of employees will not be an easy task. The existing practice has proved that voluntary leaves with redundancy pay did not bring to a significant reduction of the number of employees, and there are indirect proves that such a "rationalisation" of the number of employees had the reduction of efficiency in the public sector as a side effect since the opportunity to leave was used by the best and most wanted employees in most cases. Therefore, one should resign the voluntariness principle so as to solve this problem. That means that a detailed registry of all employees has to be made, sector plans for the reduction of the number of employees have to be developed and labour legislation has to be amended. Along with all that, it is almost sure that there will be a strong resistance of the trade unions and different interest groups. The Fiscal Council believes that the rationalisation of the number of public sector employees is one of the key reforms and supports its implementation.

The Government reform package does not include the pension reform and the fact that it is missing is striking. The current pension system is unsustainable and unfair and its reform has to be launched as soon as possible. The main deviations in the pension system of Serbia in comparison to similar systems in Europe have been familiar for a while. For example, in Serbia, there is no difference between the pension level in terms of the expected duration of receiving it; it represents fiscal expenditure, but first of all, it is unfair, since, on average, those who are retired at the age of 55 will receive their pensions 10 years longer than those who retire at the age of 65. In addition, the conditions for special early retirement in Serbia are too generous, and the gap between the age limit for women and men is the greatest one in Europe. We would like to highlight that the launch of the pension reform in the first half of 2013 was a commitment of the Government as well, since it was planned in the Fiscal Strategy for 2013. However, in 2013, not only the pension reform has not been launched but it is now even excluded from the list of planned reforms. Taking this experience in account, one could doubt the credibility of the Government commitments related to other proposed reforms as well.

Adoption of the budget rebalance presents an admission of huge pubic revenues failure to the plan. Missing revenues are the key reason for a high deficit in 2013, which is why the budget rebalance is proposed. The failure of the revenues from the value added tax, excises, profit tax are particularly striking while the non-tax revenues are also significantly decreased. The structure and the volume of the discrepancy from the plan indicates that the main reasons for that are the following: 1) optimistic planning of most of revenues during the budget drafting in November 2012; 2) changes in the macroeconomic environment (first of all, lower inflation than the expected one), but indisputably as well, 3) significant increase in tax evasion and tax non-discipline. The increase in tax evasion is clearly indicated by the data that some tax revenues are collected to a much lower level than it could have been clarified by the amended tax base (lower domestic demand, for example) and changes in tax rates.

The Fiscal Council assesses that the Republic budget revenues will be around RSD 15 billion lower than the ones defined in the rebalance. The revenues projections in the rebalance were reduced by RSD 92.3 billion in comparison to those planned in the 2013 Budget Law. Nevertheless, the Fiscal Council thinks that the revenues could be even around RSD 15 billion lower than those planned in the rebalance. The discrepancies in comparison to the latest assessment of the Government are present with both excises and VAT, while the additional failures may be recorded with some other items as well, such as profit tax, income tax and custom duties. If the Government does not make a serious attempt to implement the planned measures for the improvements in the tax collection in the following 2-3 months, there is a possibility that the Republic budget revenues deviation could be somewhat lower than the estimated 15 billion.

The Republic budget expenditure was reduced by around RSD 36 billion in the budget rebalance. If there had not been for the budget rebalance, the 2013 expenditure would probably meet the plan. More precisely, some expenditure items would exceed the plan while some of them would fall short, which, in total, would produce the expected result. The changes which were introduced by the budget rebalance refer to the decrease of the transfers to the PIO fund (Pensions and Disability Insurance Fund) of RSD 16 billion (which is indirectly affected by the changes in income tax rates and contributions) and to the savings in net value of around RSD 20 billion. The term *net* is used, since, in fact, greater savings were planned - of over RSD 35 billion (mostly subsidies and capital expenditure), but, at the same time, the expenditures will rise by around RSD 15 billion due to different liabilities (assuming the interest rates to Srbijagas credits, increased funds for the Transition Fund, financing RTS (Radio Television of Serbia), etc.).

We consider that the expenditure will still be around RSD 10 billion higher than the one planned in the rebalance. Namely, there are risks that some ambitiously planned savings will not be made to the fullest. For example, the Fiscal Council has already indicated the risk of overstepping the formerly planned framework for agricultural subsidies, since we thought that the framework is not sufficient to finance all the legal rights given to the agricultural producers. However, the rebalance implied further reduction of the framework which we consider to be unviable. We also noticed other savings which are not expected, in fact, such as the reduction of subsidies to Železnice Srbije and the decrease in allocations for commodity reserves which we are sceptical about, due to lack of adequate explanation. Finally, it may prove that the projections of some expenditure, such as the transfer to the PIO fond and expenditure for covering interest rates may be optimistic.

The public debt keeps growing and in the end of 2013 it may easily reach 65% of GDP. In the end of May, public debt amounted to around 62.8 % of GDP and in the past three quarters, when it increased by € 3.2 billion reached a record-breaking growth. Although one could hear the data in the public that the public debt-to-GDP ratio is considerably lower than 62.8%, it is mainly the consequence of some, methodologically inadequate interpretations of the public debt-to-GDP ratio during the year and the exclusion of the local self-government debt. The second claim which is present in the public – that the public debt is being stabilised in 2013 and even being decreased – is a wrong claim. We would like to stress once again that the public debt could be stabilised and reduced in the long term only by fiscal deficit reduction. Therefore, the high deficit of about 6% of GDP which will be reached in 2013 by no means can stabilise the public debt on the current level. To conclude, only sharp fiscal deficit decrease (with limitations in issuing state guarantees) can prevent the public debt crisis in the first place and then, in the second place comply with the bounding commitment on the public debt level which is an obligation of the Serbian Government pursuant to the Budget System Law.

Even if all the measures stipulated in the Government program for public sector reform would be implemented, it would not provide for fiscal stability in 2014 and in the medium run. The Government measures which relate to the savings by the end of the year, reform of state-owned and socially-owned enterprises, announced reduction of public sector employees, as well as the planned low pensions and wages indexation in October 2013 and during 2014 are good in general and the Fiscal Council supports them. Still, we think that all this will not be sufficient so as to avoid the public debt crisis in the medium term. Namely, even if all the given plans of the Government would be implemented to the fullest, the public debt growth path could not be reversed until 2017. In order to reverse the public debt growth path in the medium term, and thus avoid the crisis which is very likely, it is necessary to make additional savings in 2014 which are estimated at 1% of GDP at least.

The introduction of a temporary solidarity tax could provide for around 0.6% of GDP which is over one half of necessary savings in 2014. The Fiscal Council proposes the introduction of a tax of 10% which is calculated to the pension amounting to over RSD 25,000 and to public sector wages amounting to over RSD 40,000. Therefore, only the income amount over the given limits would be entitled to tax which means that: an employee with the wage of RSD 40,000 would not face wage reduction; an employee with a wage of RSD 50,000 would be 1,000 short; while an employee with RSD 200,000 wage would be RSD 16,000 short. Solidarity tax would relate to all public sector employees including the public enterprises and independent institutions such as Fiscal Council, State Audit Institution and National Bank of Serbia.

The state has to provide approximately € 2.7 billion by the end of the year and additional € 4.5 billion in 2014 for smooth functioning of public finances – which presents a great challenge. The given funds are necessary so as to finance the fiscal deficit and repay the mature public debt principal. Beside all this, there is a risk of additional state interventions in the banking sector or the risks if the state decides to assume some of the guaranteed debts of public enterprises. It is not likely that all the necessary funds by the end of 2013 and in 2014 could be provided through bilateral negotiations with the creditors or via public enterprises privatisation. This is why the public finances in Serbia will depend on how the market will evaluate the decision of the government to implement the reforms and reduce the deficit in the short and medium run in the period to come. Should the Government measures prove not to be convincing enough, the interest rate for Serbia's borrowing could easily exceed even 7% - which would be difficult to repay.

The Fiscal Council thinks that a new IMF arrangement should be made. Bearing in mind that the public finances stability in Serbia depends on the loans from the investors from financial markets, one has to guarantee that the Government measures are strong enough and credible to provide for the public debt path reversal. The best guarantee would be the IMF arrangement and we believe that it would be difficult to avoid a sharp interest rates growth to Serbian borrowing and possible crisis without the arrangement.