Republic of Serbia
Fiscal Council

SUMMARY OF THE REPORT "BUDGET IMPLEMENTATION, ASSESSMENT OF GOVERNMENT'S MEASURES AND FISCAL COUNCIL'S PROPOSAL FOR PUBLIC FINANCES STABILISATION"

Public finances in Serbia are in a very bad position. The fiscal deficit will exceed 5.5% of GDP in 2013 instead of the planned 3.6% of GDP, even with the latest Government measures for deficit reduction. The public debt which has already reached more than 60% of GDP will continue growing in both 2013 and 2014. So as to put fiscal trends permanently under control and avoid public debt crisis, the following is necessary: 1) stringent Government measures as early as in 2013 and 2) credible plan for deficit reduction in medium term. In order to achieve the first target, it is indispensible to adopt the budget rebalance as soon as possible and the rebalance will also have to include the measures for the control of public sector wages and pensions. To meet the second goal, it is necessary to finally start the implementation of the planned structural reforms, but also to make an arrangement with the IMF – as a guarantee to investors that the Government will make necessary fiscal adjustments and will be able to pay the accrued debts in the future.

Planned 2013 fiscal policy will not be implemented. The April data on public revenues and expenditures trends now definitely confirm the previous assessment made by the Fiscal Council (from March 2013) that the fiscal flows in 2013 are very unfavorable. In the first four months of the year, the deficit of the consolidated state amounts to RSD 61 billion and the deficit of the budget of the Republic to even RSD 78 billion. Therefore, it is obvious that the planned deficit of the consolidated state in 2013 of RSD 132 billion, i.e. of the Republic of RSD 122 billion will not be even close to reach.

In the first four months of 2013, public revenues deviate considerably from the plan, while the public expenditures are (seemingly) under control. Public revenues in the first four months of 2013 are lower that the expected revenues by even RSD 40 billion. With small deviations, public expenditures of the state in the first four months were up to the expected limits. However, one should be somewhat skeptical in the interpretation of the public expenditure trends, since some of the state interventions, which are basically public expenditures, were realized out of the budget (interventions in "Smederevo Steel Mill" (Železara Smederevo"), paying accumulated arrears, interventions in the banking sector).

We expect that the republic budget revenues will deviate from the plan by at least RSD 80 billion (2.1% of GDP) by the end of the year. The main reason for the fiscal deficit increase in 2013 is lower revenues level in the Republic budget than the expected (see section 2). In comparison to the projections from the Budget Law, three big components of the public revenues: profit tax, value added tax and non-tax revenues will fall short by approximately RSD

20 billion each (in each of the items separately). The excise revenues (around RSD 10 billion) and income tax (around RSD 5 billion) will be also considerably lower than the planned ones.

The key reason for lower public revenues lies in optimistic budget planning, not in the change in macroeconomic environment or the growth of tax evasion. Out of total amount of RSD 80 billion deviating from the planned republic revenues, around RSD 55 billion is a result of bad planning. In such a way, initially (during the budget drafting in November 2012), the revenues from profit tax and non-tax revenues and partly from the excises and VAT were overestimated. The change of the macroeconomic environment – primarily abrupt inflation slowdown – can account for RSD 20 billion of lower revenues than the planned ones at most. This change is considered an objective circumstance which lead to deficit increase, since the abrupt inflation slowdown was caused by considerable impact of unpredictable factors (food price trends worldwide and locally, strong RSD appreciation, etc.). Blocking inflation affected most to lower revenues from planned revenues from VAT. Eventually, tax evasion increase, especially in the tobacco products trade could account for additional RSD 5 billion approximately of the deficit in the budget – to the greatest extent in excises. The Fiscal Council considers that this shortfall is also due to insufficient engagement of tax authorities to prevent the increase in tax evasion after considerable increase of excise on tobacco products.

We estimate that the republic budget expenditure in 2013 will overstep the planned expenditure by around RSD 20 billion (0.5% of GDP). Expenditure growth by around RSD 15 billion is a consequence of the realization of capital expenditure for the construction of Corridor 11 and the bridge Zemun-Borča which are realized by the Azerbaijan and Chinese credit. The realization of these expenditures is difficult to the followed since they are realized directly by the Azerbaijan and Chinese companies which, still, cannot fully justify bad budget planning of these in 2013. As far as other expenditures are concerned, it is likely that the expenditures for interest rates and social protection will somewhat exceed the plan. On the other hand, some other expenditures (remaining capital investments, procurement of goods and services), may not be fully realized. By the end of the year, we also expect the increase in expenditures arising from the abolishment of monthly subscription for the public service and from full financing of RTS (Radio Television of Serbia) from the budget. The budget may also assume the obligation to pay for the “energy vulnerable customer” program (see section 3). In total, we expect that the above mentioned effects and risks will create an additional increase in expenditures of around RSD 5 billion.

The program of measures for fiscal deficit preservation will reduce the deficit by around 0.6 – 0.7% of GDP instead of the planned 1% of GDP. Faced with strong deficit increase in 2013, the Government was forced to adopt the Program of measures for fiscal deficit preservation with planned deficit decrease of around 1% of GDP. However, the Fiscal Council estimates that the greatest scope of this Program will be the reduction of the deficit by only 0.6 - 0.7% of GDP. Although, in general, we evaluate positively the amendments to the Income Tax Law and the Law on Contributions for Mandatory Social Insurance, we also think that the assessments of net effects of the amendments to these Laws to the deficit are overestimated by around RSD 5 billion. The savings measures meant to cut discretionary expenditures envisaged by the Program are not sufficiently transparent, which disables a more detailed analysis of these. Still, we believe that it will be impossible to make all the planned savings. For example, we notice that there is a plan to decrease the subsidies for agriculture which is neither consistent with the announcements made by the Ministry in the past, nor with the previous assessments of the Fiscal Council in terms of the possibility of realization of originally planned agriculture budget. Bearing in mind that there are already certain arrears in terms of agricultural subsidies in 2013, such a step may be only postponement in settling liabilities which cannot be considered as a true example of savings in that case.

The Fiscal Council estimates that the 2013 state deficit will amount to at least 5.5 % of GDP instead of the planned 3.6% of GDP. The increased fiscal deficit of the consolidated state in 2013 will be mainly due to the deficit growth of the republic budget while we expect that the other government levels will have slightly higher deficit level in comparison to the plan. The revenues of the Republic will be lower the planned ones by at least 2.1% of GDP, public expenditures will be higher than the planned ones by 0.5% of GDP. The Government measures will be able to reduce the deficit by 0.7% of GDP at most which means that the 2013 deficit will be slightly exceeding 5.5% of GDP. It is important to stress that the Fiscal Council made this assessment by using the definition of the deficit proclaimed by the Ministry of Finance and Economy. According to that definition, the state deficit does not include the payment of accumulated arrears, state interventions in the financial sector (e.g. capital increase in "Poštanska štedionica"), while there are some other methodological dilemmas which may lead to having other relevant institutions (IMF) estimate the deficit on an even higher level than the Fiscal Council. We highlight that the state interventions provided for the credit of around $ 165 million for production launch in "Smederevo Steel Mill" ("Železara Smederevo") which will be eventually financed by the Republic. For all the above given, we think that the "real" deficit in 2013 is actually higher than the estimated 5.5 % of GDP but we decided to use their definitions so as to be able to compare our data with the data provided by the Ministry of Finance and Economy.

The Fiscal Council thinks that the public finance state-of-play in Serbia requires much more serious measures than those proposed and that the budget rebalance is an immediate imperative. The time for serious interventions which could create significant savings in the budget by the end of the year is running out. This is why we believe that it is necessary to start drafting the budget rebalance immediately. If the Government proves to be able to keep the 2013 budget deficit on the level below 4.5% of GPD, we could consider that a success – taking into consideration the current fiscal flows. It is unlikely to make additional savings of over 1% of GDP in only several months left until the end of the year without some of strong measures which would be a basis for such savings. In addition, wages and pensions increase in October would be very fiscally irresponsible under these circumstances.

The Fiscal Council estimates that the 2014 deficit must not exceed 3% of GDP. It would mean that we need fiscal adjustments of at least 1.5 % of GDP in 2014 in comparison to 2013 (although it is more likely that even bigger adjustments will be necessary if the 2013 deficit reaches a higher level). It is important to stress that even the deficit of 3% of GDP still does not lead to public debt reduction in 2014, which was the original target of the launched fiscal consolidation. However, we think that that level of deficit which can be reached only by strong adjustments in 2014 would represent a clear signal that the Government is determined to commit to fiscal consolidation and to putting public finance in order (see section 7).

It will be necessary to include the control of public sector wages and pensions in 2014 budget as well. Structural reforms planned in the fiscal consolidation package are not implemented, which reduces the possible sources of savings and of deficit reduction in 2014. Therefore, so as to make necessary deficit reduction in 2014, the Government has a very limited number of measures at its disposal – the increase in the rate of a generous tax and/or wage and pension control. The Fiscal Council believes that the tax increase should not be even considered since the public finances problem in Serbia is not a low level of public revenues but a high level of public expenditures. For this reason, the Fiscal Council thinks that the control of the public sector wages and pensions in 2014 is inevitable and economically justified. The average public sector wage is 30% higher than in the private sector, Serbia being a European record holder in a negative sense, while the security of jobs in the public sector is much greater than in the private sector. If one has a look at the share of wage and pensions bill in GDP, Serbia is again holding a European record in a negative sense.

The implementation of structural reforms should be launched immediately, since, otherwise, we will be in a similar situation to the one in 2013. With the expert support of some other relevant institutions (World Bank, IMF), in several reports (since May 2012), the Fiscal Council proposed comprehensive public sector reforms and presented them in detail: rationalisation of the number of employees in the public sector, pension reform, reforms in state-owned and socially-owned companies, subsidies system reform, improvement in the system of tax collection, reduction of grey economy, etc. The implementation of these reforms would create significant savings in medium term, but also improve the business environment and contribute to the economic growth. The Ministry of Finance and Economy accepted most of the proposed reforms and included them in the Fiscal Strategy which was adopted by the Government in November 2012 but still almost none of them were launched. Structural reforms are specific because their more apparent effects to the deficit may be expected only one year upon their launch, and, as a rule, they are rather politically unpopular. Still, if the reforms had been launched in October 2012, the fiscal position in 2014 would not have been even nearly as uncertain as it is now. Therefore, it is necessary to launch the implementation of the reforms immediately since there is a danger of facing a similar uncertainty again during the 2015 budget drafting – each time with less room to maneuver.

The public debt overstepped 60% of GPD and it will continue growing in both 2013 and 2014. Although one can hear the evaluations made in public that the public debt has reduced in 2013, it actually continues growing very fast. Since the beginning of the year till the end of April, public debt was increased by approximately € 1.5 billion – from around € 18 billion to around € 19.5 billion. It is almost certain that the public debt will exceed even € 20 billion by the end of the year. The illusion of reduced public debt was created primarily because of strong appreciation of RSD against Euro but also due to some methodologically inaccurate interpretations of the public debt share in GDP during the year (see section 8). The only way to stabilize and reduce the public debt in the long run lies in the fiscal deficit decrease, and the 2013 fiscal deficit, even the 2014 deficit will be very high. Even with the 3% of GDP deficit in 2014, which will ask for strong fiscal adjustments, public debt share in GDP will continue growing even in 2014. Naturally, it is possible that some of bigger privatisation procedures may be realized in 2014 (or even sooner) and it may cause a one-off public debt reduction. However, it could not change the trend of public debt growth, but only lead to one-off reduction of its level.

The main aim of fiscal consolidation – blocking public debt growth in the end of 2013 and its decrease as of 2014 will not be reached and therefore, it is necessary to make a credible medium term plan for deficit reduction, supported by the IMF. The reversal in the growing public debt path is possible in 2015 at the earliest. Moreover, it is possible only with very strong fiscal deficit reduction in the meantime (see graph 8.2). With inadequate deficit reduction in 2013 and postponement of the implementation of structural reforms, Serbia is now in a very dangerous situation again with public debt crisis prospects. For this reason, the investors' feeling of trust will depend on the fact whether Serbia has a credible medium-term plan for fiscal deficit reduction, and the state budget financing is currently depending on investors. Otherwise, if the public debt keeps growing in the medium term as well, the state will no longer be in a possibility to pay the accumulated debts and the public debt crisis is inevitable. The Fiscal Council considers that it is ever more likely that the investors consider the medium-term Government program for deficit reduction credible without signing of a new arrangement with the IMF.

(Note: The Fiscal Council's reports are available on the website www.fiskalnisavet.rs)