Republic of Serbia
Fiscal Council

ASSESSMENT OF THE DRAFT BUDGET FOR 2021

Summary:

The 2021 budget should have been planned more restrictively, due to the high uncertainty that the next year brings. The budget proposal for 2021 envisages a central government deficit of 178.5 bn dinars (3% of GDP) and a slightly higher general government deficit of about 180.3 bn dinars. This plan, however, rests on the optimistic assumption that the GDP growth in 2021 will amount to a high 6%, which could easily not materialize. In case of a lower economic growth, public revenue would not come in at the planned level, so the deficit could be significantly higher than 3% (and close to 4% of GDP), while the public debt share in the GDP would continue to grow (over 60% of GDP) instead of coming to a standstill. If the non-favourable epidemiologic circumstances continue into 2021, perhaps the economy will require a new (certainly smaller) assistance package, which would be an additional burden on public finance. Due to so many uncertainties, we assess that the 2021 budget should have been planned more carefully, with a deficit of 2% of GDP, like the Fiscal Council recommended to the Government in November 2020. This could have been accomplished primarily by freezing the salaries in the public sector (or by their minimal indexation), as well as by delaying or abandoning the projects that are not urgent for 2021 (immense expenditures for the equipment in the security sector, construction of the Trebinje airport, subsidies for digital fiscal registers, subsidies for taxi drivers, increased expenditures for incentives to attract investors etc.)

We therefore recommend to the Government to start implementing the low priority projects for 2021 only when/if they are convinced of a strong economic recovery. By far the largest share of the government expenditures are defined in legislation and their schedule cannot be disrupted (pensions, salaries of the general government employees, welfare etc.) In addition, there are expenditures that are important for the health and quality of life of the population, as well as for economic recovery (equipping the healthcare system, investments into basic infrastructure etc.) Such projects need to be implemented as efficiently as possible. The remainder of the planned expenditures that the Government manages at its discretion should be very strictly controlled, for as long as uncertainty persists. Already in the spring of 2021, we will have far more information about the epidemiologic situation, the rate of economic recovery and the budget revenues collected – and thus we propose that the Government wait a couple of months before spending the budget funds on projects that will lead to an increase in deficit, which are not significant for economic growth or population health and which may easily be postponed. If, after a few months, it transpires that the health crisis will take longer than expected, it is justified to postpone some of these projects for upcoming (better) years, to prevent too large an increase of deficit and public debt in 2021.

The largest structural (lasting) issue in the 2021 budget that will be hard to rectify are the excessive expenditures on subsidies and salaries in the public sector. In addition to the aforementioned projects, the foundation of the relatively high 2021 deficit is comprised of four large budget expenditure components which cannot be postponed, and which had been increased significantly above their sustainable levels during the health crisis. These are: 1) healthcare expenditure; 2) pensions; 3) salaries in the public sector; and 4) subsidies and net budget loans (hereinafter: subsidies). The first two deficit factors (increased expenditures on healthcare and pensions), even though they are above their sustainable levels, are generally adequate and should not represent a permanent source of public finance instability. However, the remaining two main deficit factors from 2021 (high subsidies and salaries in the public sector) are much more dangerous and represent a serious structural public finance problem. To resolve this issue, salaries in the public sector need to grow at a lower rate than the economic growth for many years (and at a slower rate than the salaries in the private sector) and the most important public and state-owned enterprises need to finally be fundamentally restructured. The experience from previous years teaches us that this will be a major challenge. Below is a more detailed review of the deficit components for 2021.

1. *Increased expenditures on healthcare*: the government plans to continue its extremely high expenditures on the support to healthcare in 2021 (equipping healthcare institutions, procurement of medicines, materials etc.) In the national budget, this is visible in the transfers to the NHIF (National Healthcare Insurance Fund), which are extraordinarily higher in 2021 by over 0.8% of GDP compared to their pre-crisis level. The Fiscal Council assesses that increased healthcare expenditures are justified. What we have noticed, even during 2020, is that exceptional expenditures on healthcare in Serbia exceed, as much as twice, those of the comparable Central and Eastern European (CEE) countries. The most probable reason why Serbia needs to allocate far more funds during the crisis lies in the fact that the crisis has found our country's healthcare system far worse equipped than those of other CEE countries. Eurostat data shows that, before the crisis, Serbia lagged significantly behind CEE countries both by the number of basic medical equipment items and by the number of beds for in-patient treatment of particular illnesses, per 100,000 inhabitants. The Government did, indeed, manage to procure extremely large quantities of the necessary healthcare equipment under aggravated circumstances, invest into the existing facilities and the construction of new facilities, and it plans to continue with these efforts in 2021 as well, which is excellent. However, on the other hand, the question is why we had to wait for a crisis in order to increase these investments - all the more so since the Fiscal Council has been warning about this issue for years. An extraordinarily high investment into healthcare also cannot represent a long-term source of fiscal imbalances (deficit). Namely, when the construction of all four planned clinical centres completes (funds were provided as far back as 2008), and other major investments into equipment and infrastructure are complete - investments into healthcare will automatically decrease.

2. *Pensions:* another important source of deficit in 2021 is the increased expenditure for pensions, which will be about 0.4% of GDP above their sustainable level. This imbalance was created when the growth rate of pensions exceeded the economic growth in 2020 and 2021. In 2020, the nominal pension increase was 5.4% and in 2021, they are envisaged to grow again by another 5.9% - meaning that the real growth of pensions in these two years will amount to about 8%. In the same period, cumulative GDP growth will amount to about 5%, according to the Government's optimistic forecasts (1% drop in 2020 and 6% growth in 2021),

and it is very likely that the GDP will come in much lower than that due to the ongoing public health crisis. However, the Fiscal Council conditionally supports the planned pension growth in 2021 even though it is not justified by the current economic trends. The growth of pensions in 2020 and 2021 is the result of the application of an objective rule ("Swiss formula"). In crises, this formula has pensions growing at a higher rate than GDP (as is the case now), but in good times, it results with a somewhat slower pension growth rate - when the pensions should automatically return to their sustainable level of about 10% of GDP. Hence, the Fiscal Council supports the planned pension increase in 2021, but only under the condition that the Government continue to adhere to the Swiss formula consistently, after the crisis ends. An important legacy of the pension system, which was abandoned in 2008 and then painstakingly reintroduced in mid-2019 was to increase pensions in Serbia (like in all other fiscally disciplined countries) exclusively in line with objective parameters. The other practice of increasing the pensions by discretionary decisions of the Government instead, is detrimental even when it seems, at first glance, to be favourable for the pensioners. The pensioners had a painfully clear opportunity to see this during the fiscal consolidation in 2015, and such mistakes should not be repeated.

3. *Salaries in the general government:* same as for pensions, the growth of salaries in the public sector in 2020 and 2021 far exceeds economic growth, which is why the budget expenditures on salaries in 2021 will be at an unsustainably high level, we estimate by about 0.6% of GDP above their sustainable level. There are, however, two key differences that make the issue of excessive expenditures on the public sector wage bill far more dangerous than that of the pension bill. *Firstly,* there is a far greater discrepancy in the growth rate of salaries compared to the rate of economic growth, than is the case with pensions. A cumulative increase of general government salaries in 2020 and 2021 amounts to over 11% in real terms (nominal growth of 10% in 2020 and 4.6% in 2021). This means that the salaries of the budget beneficiaries have grown twice as fast as the economic activity (that funds it) over these two years. The largest issue is the excessive salary growth of 10% in 2020. As an illustration, the salaries in the public sector in 2020 and 2021 would cumulatively outgrow the economic growth even had the Government listened to the Fiscal Council recommendation from November 2020 and kept them frozen in 2021. *The second* major issue with salaries in the public sector is that they (unlike pensions) are not systematically regulated, and their growth is not anchored to objective economic parameters (introduction of a comprehensive pay grade system has, once again, been postponed for 2022 although it had been announced for 2015). This means that, unlike pensions, there is no rule that will automatically bring back the salaries in the public sector to their sustainable level in a few years. And if the salaries in the public sector grow significantly even at a time of crisis, it is difficult to expect that such practice will be abandoned at a time of economic recovery. Economic reasons why the growth of salaries in the public sector must slow down, include not only fiscal stability, but also the fact that the salaries in the general government are already by about 20% higher than in the private sector, despite higher job security. Such a large privilege of the public sector compared to the private sector is economically harmful, in the long run.

4. *Subsidies:* overall expenditures on subsidies (including budget loans) planned for 2021 are also unusually high - about 0.8% of GDP above their sustainable level in the long-term. An additional issue with subsidies is that the proposed budget does not explain the specific purpose for a large share of these funds. All things considered; it seems that state aid to Air Serbia is one of the important reasons for the extraordinary increase of subsidies in 2021.

A detailed analysis shows that the public health crisis was only a trigger for the state aid and that a major part of what is now being covered from the budget comes from the company's many years of poor performance (see Chapter 6). Even when the planned state aid to Air Serbia is paid out; it is difficult to expect that the overall government expenditures on subsidies will decrease. Namely, almost every year certain public and state-owned enterprises need assistance from the budget for their accumulated debts and liabilities, due to their poor performance. This expenditure is generally higher at a time of crisis, but it also appears in good times, as well. Thus, in 2021, this expenditure is aimed at the company Air Serbia; in 2020, it was Air Serbia and EPS; prior to that, Srbijagas, Petrohemija etc, and the subsidies for the consolidation of PEU Resavica have become a traditional item in the budget, repeating every year, while the problem goes on, unresolved. Poor performance of the state-owned enterprises is one of the largest structural issues in Serbian public finance, and it has been the topic of Fiscal Council's analyses and specific recommendations to the Government for years now - but there are no credible signs that any efforts will be invested in its resolution (the first detailed and comprehensive study on the state-owned enterprises was written by the Fiscal Council in 2014, after which we continued with additional analyses of this major issue. The last published comprehensive study was on EPS, in 2019).

The proposed budget also has some good elements, the best being the increase in public investments, now planned at a very high level in 2021. The 2021 budget envisages record-breaking capital expenditures of the Republic of Serbia, in the amount of 274 bn dinars; at the consolidated government level (including local governments, JP Putevi Srbije, funds of mandatory social insurance), about 330 bn dinars of investments are planned in total (about 5.5% of GDP). Although a part of these investments is the consequence of the strong, but temporary increase of investments into the healthcare sector, it is important to point out that the government's investments into the road and railroad infrastructure have not been decreased during the crisis of 2020 and will remain high in 2021. This means that one of the larger mistakes of the economic policy in Serbia after the world economic crisis in 2008, when public investments were decreased instead of increased, was avoided during this crisis. Increased expenditures on public investments are especially important in a crisis period, as this is the best fiscal policy measure for incentivizing economic recovery. In addition, higher investments into infrastructure in Serbia are very much needed since the basic infrastructure is in very poor condition.

The proposed budget continues with pronounced non-transparency in displaying public expenditures, which started in 2020. The poor practice of insufficiently transparent presentation of public expenditures, which was very pronounced in the two supplementary budgets in 2020, continues with the Draft Law on Budget for 2021 as well. We have identified about 800 m Euros of expenditures in the 2021 budget with no concrete legal or other explaining document that would, even indirectly, indicate what their particular purpose is. The Public Investment Management Office (PIMO) particularly stands out by the lack of transparency, commanding a budget of as much as 21.2 bn dinars in 2021. These funds have been presented within two programs with generic titles: "Coordination of the tasks of rehabilitation and construction of public facilities" and "Implementation and management of the projects for research and development revitalization in the public sector in the Republic of Serbia" - without any additional explanations. Although this should comprise generally justified investments (reconstruction of primary and secondary schools, primary healthcare facilities and certain hospitals, elderly care homes, social protection institutions etc), a complete list of projects planned to be implemented during the year needs to be presented, as well as clear criteria based on which they were selected as priorities. This would show whether the budget funds were being invested where they are objectively most needed, or are steered by discretionary, ad-hoc decisions. In addition, if the budget were to show a detailed investment plan to be implemented through the PIMO, at the end of the year it would be possible to assess to what degree this plan had been implemented, i.e., whether all that had been planned, had indeed been built. Together with those of PIMO, expenditures for the Republic of Serbia's equity in companies, subsidies for air transport, public road construction enterprises and the investments of the Ministry of Defence are all completely non-transparent.

Investments into communal infrastructure and environment protection have, once again, been neglected. The 2021 budget does not plan for a major increase in capital expenditures for these purposes - although these are probably the most neglected segments of public infrastructure which pose a serious risk for the health of the population. Line ministries (Ministry of Environment Protection and Ministry of Construction) plan only about 25 million Euros of investments in total, for the improvement of communal infrastructure and environment protection. Fiscal Council's analyses, however, show that Serbia should invest, at the very least, 4 times as much in these areas. It is not impossible that PIMO will start implementing investments into environment protection as well, from their (undefined) expenditures, in 2021. Funding for this has been provided, i.e. there is an approved loan from the Development Bank of the Council of Europe, in the amount of 500 m Euros, for the Project of improving infrastructure for the protection of the environment - which has now reappeared in Article 3 of the proposed Draft Law on Budget for 2021. However, this approved loan had already been featured in the budgets for previous years, but not a single Euro has yet been withdrawn for this purpose, nor has any related project started with implementation. It is not very likely that there will be a decisive change in 2021 in the Government's attitude towards the protection from environmental pollution. This situation, with insufficient investments into environment protection and communal infrastructure is somewhat reminiscent of the many years of insufficient investments in healthcare, which were only significantly increased when the public health crisis broke out in 2020. Bearing this experience in mind, it would not be good to repeat the same mistake and wait for an environmental crisis in order for the budget funds to finally be steered towards reducing the pollution in the country.

Public finance in Serbia is currently far from a crisis, which does not mean they can be managed with less responsibility. In crises such as this, there are sometimes public statements of excessive pessimism in assessing the state of the national budget (as well as statements of the public officials that the budget is in an impeccable state, which is also not true). This emphasizes the role of the Fiscal Council, to independently confirm that public finance in 2021 will not be in any fundamental danger. Despite the global health crisis, Serbia is currently not even near any real danger of a fiscal crisis, and the government will certainly be able to meet its financial obligations in time in the upcoming period. This is the direct result of the successful fiscal consolidation from 2015-2017, and the painful measures it encompassed. All this, however, does not mean that it is now justified for the government (i.e., the entire population of Serbia) to take out a 600 m Euro loan (with interest) to hand out 100 Euros to every adult citizen in the midst of a crisis. It is also unjustified for the government to take out an additional 150 m Euro loan, in that same crisis, to provide for an increase of salaries in the public sector in 2021 which is not backed up by economic trends. It is not justified, either, that the taxpayers should fund unsuccessful performance of one of the state-owned enterprises, year after year, where the employees - as a rule - have higher salaries than the employees in the private sector. Equally important questions to discuss are to what extent is it justified that Serbia should invest, for years, three times more than comparable countries into equipping the army and the police, grant huge budget funds to construct an airport in Trebinje, while at the same time being one of the most polluted countries in Europe. It is important to note that the proposed budget is the third fiscal document in a row (after the two supplementary budgets of 2020) with pronounced non-transparency. These examples illustrate the current scope of problems faced by the public finance in Serbia - and the Fiscal Council will warn the public in due time, if the country's finances do indeed get into serious trouble, which is not the case yet.