Republic of Serbia
Fiscal Council

ASSESSMENT OF THE PROPOSED SUPPLEMENTARY BUDGET FOR 2020 AND RECOMMENDATIONS FOR FISCAL POLICY IN 2021

Summary:

The proposed supplementary budget shows that the healthcare crisis has hit the budget far harder than expected, so bringing the public finance back under control will be challenging. Supplementary budget envisages a record-breaking national budget deficit of 483 bn dinars (8.8% of GDP), while the general government deficit is planned at 492 bn dinars (8.9% of GDP). This is by far the highest fiscal deficit Serbia has ever recorded, exceeding the previous record-breaking deficits of 2012 and 2014 by about 40%. At that, comparative analysis shows that Serbian 2020 deficit will be among the highest in the CEE (where the average deficit will amount to 7.5% of GDP). All this cannot be explained solely by the effect that the GDP decline has had on public revenue, or by immediate expenditures of the implemented anti-crisis measures. A good share of the 2020 deficit arose exactly because the healthcare crisis has laid bare the problems that had been swept under the carpet for many years. Years of insufficient investments into healthcare in Serbia meant that a significantly higher share of the budget had to be set aside for this purpose in the current crisis, than was the case in comparable countries - for the procurement of necessary equipment and improvement of healthcare infrastructure. Problems of the state-owned and public enterprises (Air Serbia, EPS) are not recent, either. The crisis was merely a trigger for state intervention which covered a part of the expenditures of their failing performance in 2020 - which would probably have happened even if it weren't for the crisis. At that, the year will end with unsustainable expenditures for salaries in the public sector as they have been excessively increased in 2020 (by about 10%), with the GDP suffering a real decline of about 1.5%. For all these reasons, the enormous fiscal deficit planned by the proposed rebalance opens a key additional issue - how will the Government establish control over all these expenditures in the upcoming year, bringing public finance back to order?

The supplementary budget presents a credible plan for the basic macroeconomic and fiscal aggregates - deficit, public revenue and public expenditure. Macroeconomic assumptions used for the elaboration of the supplementary budget are well founded in the trends observed in the first nine months of 2020 and are similar to Fiscal Council forecasts. There is a small difference in the assessment of the GDP decline in 2020, since we expect the drop to be deeper than 1% (expected by the Ministry of Finance), i.e. that it will amount to about 1.5%. However, this is not a significant difference and at the time of increased uncertainty, forecast

discrepancy to some degree is understandable (as long as they don't have a strong impact on budget forecasts). Similarly, the overall revenues and expenditures of the national budget have been planned credibly in the amending budget. Hence, there is no risk that of the national deficit exceeding the planned 8.8% of GDP. It is possible, actually, that a somewhat smaller deficit than 8.8% of GDP will be achieved in the end, as the budget framework for individual items (interests, social protection) has been planned a little more comfortably than in our calculations.

It is good that public investments into infrastructure have not been decreased during the crisis. The supplementary budget actually significantly increases public investments compared to the previous supplementary budget from April and compared to the initial budget going into 2020. Compared to the originally planned budget, investments have been increased by about 27 bn dinars (230 m Euros) and the main reason for this was an increase of the expenditures for the procurement of new medical equipment and construction and furbishing of Covid hospitals, which we estimate at 200 m Euros. On one hand, it is good that the Government was able to react quickly to the healthcare crisis and direct significant funds for these purposes. However, the problem is that we found ourselves in this situation to begin with. For many years, the Fiscal Council has been warning the Government, quite unsuccessfully, of the insufficient investments into healthcare (as well as education and communal infrastructure) and the need to allocate significantly larger funds in the budget for these purposes. What is also important to point out is that, in this crisis, there has been no decrease of public investments into transport infrastructure, and that even they have been somewhat increased compared to the initial plan - which is good from the economic viewpoint.

The grave shortcoming of the proposed supplementary budget is a non-transparency of public expenditure, which is additionally increased compared to the previous budgets. The proposed supplementary budget actually takes a large step back when it comes to detailed and clear presentation of government spending. The national deficit has been increased compared to the previous plan, from April, by an additional 850 m Euros (from about 7% of GDP to 8.7% of GDP), mostly by adding new expenditure items, the purpose of which has not been presented clearly. It has not been explained what exactly will be covered by a 150 m Euros increase of the net budget loans (we suppose that the majority of these funds will go to Air Serbia). The Public Investments Management Office got an additional 100 m Euros without any explanation as to what the funds are intended for, which is unexpected since the same document, for example, shows the investment projects from the Ministry of Construction budget line in a very transparent manner. It has also not been explained why the investments of the Ministry of Defence have been increased by about 100 m Euros (costs of the construction and furbishing of Covid hospitals can only account for about a half of this increase). Furthermore, there are new budget items in the supplementary budget of 40 m Euros for subsidies in the electrical power sector (most probably intended for EPS), subsidies for air transport of 35 m Euros (most probably intended for the construction of the Trebinje airport) etc. Serbian taxpayers would have to have a far more detailed view of how their funds are being used – which is something that the Fiscal Council clearly warned about when assessing the first supplementary budget for 2020, this April. At that time, we had some understanding for the lack of transparency in presenting public expenditures, since that budget plan was elaborated using an emergency procedure, with the purpose of maximizing the efficiency of implementing the anti-crisis measures package. Now, however, there is no justification for such an approach by the Government in the preparation of the new supplementary budget.

The enormous increase of the fiscal deficit in 2020 is not solely a consequence of the healthcare crisis impact on the budget, but also of the structural weaknesses and irrational economic policy measures. In 2020, Serbia will have a significantly higher budget deficit compared to CEE average (8.9% of GDP compared to 7.5% of GDP). This is an unexpected result, having in mind the fact that Serbian economy was less affected by healthcare crisis than other CEE countries (we expect a GDP decline of about 1.5%, compared to about 5% in CEE). With this milder decline in economic activity, Serbia should also have a far lower deficit than CEE countries - which has not happened. The true reason is that Serbia is the only CEE country that has implemented the expensive and economically inefficient measure of paying 100 euros to all citizens of legal age, which (unjustifiably) increased Serbia's deficit by an additional 1.3% of GDP. The second reason is that, during the crisis, the many years of insufficient investments into the healthcare system have come back to haunt us. This is why the healthcare expenditures in Serbia had to be about 0.6% of GDP larger than in CEE countries during this crisis. Finally, the crisis has laid bare the weaknesses in the performance of state-owned and public enterprises (Air Serbia, EPS), which have received assistance from the budget in the overall amount of 0.4-0.5% of GDP. Thus, had Serbia not entered the crisis with public finance structural weaknesses and had it not implemented non-rational economic policy measures, the government deficit would have been about 6.5% of GDP instead of 8.9% of GDP. In this case, Serbian fiscal deficit would have been far under the average of CEE countries, i.e. consistent with its lower economic decline in 2020.

The public debt will grow sharply in 2020 – from about 53% of GDP to about 60% of GDP, which is unsustainable for Serbia. The high fiscal deficit leads to a strong public debt increase in Serbia in 2020. This increase would have been even bigger had the government not had unusually high deposits prior to the healthcare crisis (among other things, it had, on its balance, the funds from Airport Nikola Tesla concession fee). Hence, a large part of the budget gap, which in 2020 amounts to about 4.2 bn Euros, is financed by loans and public debt increase, but a small part of the deficit was covered from the government's own funds (we, as well, expect that the funds received from the sale of Komercijalna Banka by the end of the year will be used for covering the deficit). A public debt of 60% of GDP is too high for Serbia. Interest rates that will be paid for this debt are, on average, twice as high as those in the developed countries of Western Europe, and by about 50% higher than in CEE countries. Hence the of public debt in the amount of 60% of GDP in Serbia corresponds to the public debt burden of about 120% of GDP in developed EU countries – i.e. it is too high and unsustainable in the long run. In order to stop the potentially very dangerous public debt increase in Serbia and to start decreasing it in the upcoming years, a sharp decrease of the fiscal deficit in 2021 will be necessary.

Exaggerated optimism in the macro-economic forecasts can present a serious fiscal risk - which is why Government shouldn't plan GDP growth higher than 4% in 2021. Healthcare crisis is not over yet and we need to be especially careful in our forecasts of economic trends for the upcoming year. If the Government projects public revenues and indexes public expenditures on the grounds of excessively optimistic economic recovery forecasts - and then such forecasts fail to materialize - Serbia could easily find itself in massive fiscal trouble. We see current forecasts for Serbia done by national, and even some international institutions, as optimistic. For example, IMF forecasts Serbian GDP growth in 2021 at 5%, the NBS at 6%, and some government officials announced that economic growth in the upcoming year will even exceed 6%. It’s not impossible for such forecasts to come true, but the fact remains that 2021 will also be a year of uncertainty, meaning that no current forecast can be sufficiently reliable. At that, along with the arguments supporting fast economic growth in 2021, there are equally valid arguments that it could come well under the expected level. First of all, in 2020 Serbia will have smaller decline in economic activity than most European countries, meaning that it will not be able to count on the effect of a low base for calculations (which would allow the growth to be high). In other words, since the sectors that have not experienced a significant drop in production in 2020 in GDP, like agriculture and food processing industry, have a relatively high share in GDP, this has saved Serbia from a deeper drop of production in the current year – but that also means that these industries don't have the potential to ensure a fast economic growth in the upcoming year through their strong recovery. Secondly, in 2020, there was a strong contraction of FDIs which, in previous years, served as an important driver of economic growth. The last data for August show that FDIs were decreased by as much as 64% compared to the same month in the previous year. It seems likely that these trends will continue for a while. Thirdly, the latest epidemiological data shows that the healthcare crisis is far from over, so its negative impact on economic trends in 2021 must not be overlooked.

To reverse the growth of public debt in 2021, it is necessary to plan the fiscal deficit for the upcoming year at about 2% of GDP. With the estimated GDP growth of 4%, the upper limit of the fiscal deficit - which does not increase the share of public debt in GDP - amounts to about 2.5% of GDP. Bearing this in mind, the Fiscal Council recommends to the Government to plan a budget deficit of about 2% of GDP for 2021. Namely, deficit of such level would bring back the disrupted fiscal stability - in case of the expected economic recovery, the public debt-to-GDP ratio would again start decreasing, and the share of public debt in GDP would not grow much even if the economic growth in 2021 fails to deliver on its promise. A fiscal deficit somewhat larger than 2% of GDP could only be economically justified if, within this extended scope, certain funds were to be reserved for increased healthcare expenditures (in case there is a new wave of the pandemic in 2021). These funds reserved in the budget would allow for a quick and efficient reaction of the government if needed, but they should not, at any cost, be used for any other purpose if the healthcare situation does not call for their use.

Sharp fiscal deficit decrease will be a major challenge in the upcoming year. In 2021, the fiscal deficit will certainly decrease, since a new anti-crisis package commensurate to the one from 2020 (which cost the budget 6,6% of GDP) is not expected (or, indeed, possible) in the upcoming year. However, reaching a fiscal deficit of about 2% in 2021 will not be easy nevertheless, since public finances in 2021 will exhibit structural weaknesses and increased budgetary obligations/liabilities. For instance, a direct consequence of the strong increase in public debt in 2020 will be a rise in interest expenditures in 2021. In addition, the Government is legally obliged to increase pensions (and these are the single largest government expenditure) by about 6% in 2021 as required by the Swiss formula. The greatest structural weaknesses going into 2021 is the unreformed public and state-owned enterprise which could require additional state aid, just like they did in 2020. At that, it is possible that state aid may even be necessary for certain industries in the private sector in the upcoming year (e.g. hospitality industry). We would also like to point out, once again, that no room for savings should be sought in the decrease of public investments into infrastructure. These investments are not only necessary due to the very poor state of infrastructure in the country, but they are also economically important as they are the most efficient measure of fiscal policy to incentivize economic recovery.

The most important anchor for fiscal stability in 2021 is firm control of salaries and wages in the public sector. Increase of taxes should not be a way to decrease deficit in 2021, as this would have a negative impact on economic growth. On the expenditure side, there are not that many measures available that could stabilize public finances. When pensions are excluded, as their increase in 2021 has practically already been defined, as well as public investments into infrastructure (which must not be decreased at any cost for economic reasons), what remains as the most important anchor of fiscal policies are the salaries in the public sector, which must be firmly controlled next year. Wage bill control is not just critical for stabilization of public finance in 2021, it is also economically justified. First, public wage bill is unsustainably high at the moment. This was contributed to by their extremely sharp growth in 2020 of about 10%, which coincided with a decline in economic activity of 1.5%. In addition, salaries in the public sector are far higher than those in the private sector while job security in the public sector is better. Namely, public sector employees have about 20% higher average salary than those in the private sector, and this difference cannot be explained solely by the higher qualification level of the employees in general government (in national public enterprises, this difference is even higher and amounts to as much as 40%). For all these reasons, the growth of salaries in the public sector should be frozen in 2021, or, in the best-case scenario, they could be allowed to increase in line with the inflation (not more than 2%, but only if detailed fiscal analyses show this to be possible). One of the alternatives could be, perhaps, to reward - even if symbolically - those employees in the public sector who work in circumstances of increased risk or are given a higher workload during the crisis, such as the ones working in healthcare and education. Remaining employees in the general government, unlike the ones in the private sector were well protected from salaries decreases and layoffs and have during the crisis enjoyed relatively high wages and job security. Therefore, it is not justified to put the fiscal stability of the country at risk in order to cater to demands of public sector employees.