Republic of Serbia

FISCAL COUNCIL

EVALUATION OF FISCAL TRENDS AND STRUCTURAL REFORMS IN 2016

Summary

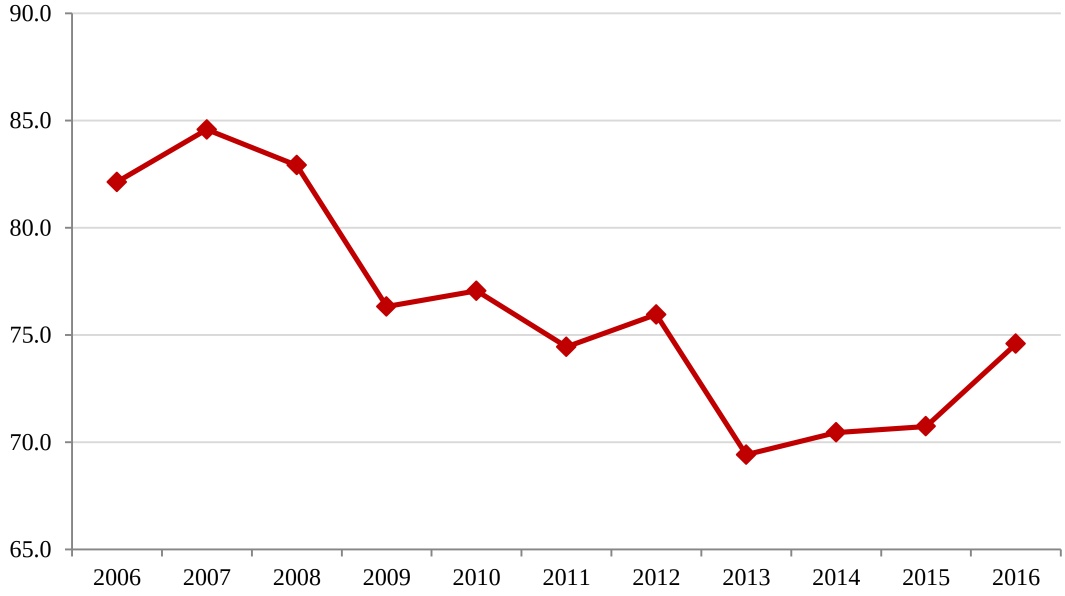
The budget part of fiscal consolidation is going well so far, but the reform part, which is crucial for permanent recovery of Serbian public finances, is running considerably late. Success of the initiated fiscal consolidation is measured by the realization of *specific fiscal objectives* (decrease of fiscal deficit and large public debt) but also by the realization of equally important *reform objectives*. Successful reforms should improve the structure of public expenditures, decrease future fiscal risks and provide support for a high and sustainable economic growth in the medium term - in other words, allow for a permanent recovery of Serbian public finances. Results achieved so far indicate that the realization of *specific fiscal objectives* has been adequate and, in many ways, even faster than planned. However, the very modest progress in implementing the reform segment of fiscal consolidation is far from satisfactory. It is thus very dangerous that a part of the broader, and even expert public, is forming the opinion that the fiscal consolidation is practically completed, i.e. that the problems of national public finances have been resolved by the significant decrease in the general government deficit. While not diminishing the importance of the budget improvements achieved, the Fiscal Council emphasizes that the achieved fiscal result of 2016 should be observed in the light of the overall status of national public finances, which is not even close to good yet. Proper interpretation of the fiscal consolidation results achieved is all the more important when put into the context of the announced salary and pension increase in 2017, as this growth of expenditures, with all the unresolved structural problems of public finances in Serbia, could very well turn out to be premature.

The fiscal deficit in 2016 will amount to about 2% of the GDP, which is a very good result, as it will be half of what was planned for this year. Based on general government revenue and expenditure trends, taking into consideration the announced expenditure increase of about 200 m Euros at the end of the year (takeover of Petrohemija's debt and payment of a one-off financial assistance to pensioners), we estimate that the fiscal deficit will amount to about 2% of GDP in 2016 (approximately 700 million Euros). This is a very good result bearing in mind that this fiscal deficit is a half of what was officially planned for 2016 (4% of GDP). Lowering of the deficit to about 2% of GDP in this year is especially important as it allows for a mild decrease in public debt (with regards to GDP) a year earlier than planned. However, there are several reasons why this deficit is still high and excessive fiscal relaxation problematic and dangerous. *First*, Serbia, with its public debt of 74-75% of GDP is still a highly indebted country and it would only take a single large external shock to drag it back to the rim of a public debt crisis. To decrease the public debt down to a safer level (60% of GDP at most), the deficit needs to be lowered in the medium term to about 0.5% of GDP by additional savings, then kept at that low level for several additional years. *Second*, the good fiscal result of 2016 has not been achieved via a decrease in public expenditures to a level appropriate for the national economy (as was originally planned) but rather through a surprisingly high public revenue collection - the sustainability of which is not completely certain. *Finally*, by postponing the public sector reforms (primarily in public and state-owned enterprises), the same fiscal risks remain - and could, in the upcoming years, practically annul the good fiscal consolidation results achieved so far.

However, implementation of reforms has ground almost to a halt in 2016, with the increase in public investment being probably the only bright point. Sustainability of the achieved fiscal results and further decrease in fiscal deficit shall depend crucially on perseverance in the implementation of public sector reforms: 1) reform of public and state-owned enterprises (EPS, Srbijagas, RTB Bor, Azotara etc); 2) Tax Administration modernization and capacity building (without which further increase in public revenue collection will hardly be possible; even current collection rate could be in danger); 3) bringing to order the unsustainable finances of certain local governments (which are, at the moment, accumulating debt in the form of arrears) and local public enterprises; 4) reform of public administration (optimization of staff number and structure, together with a salary reform); and 5) increasing public investments from the current 3% to over 4% of the GDP. Except for the public investments, which have seen a considerable increase in 2016, none of the remaining important reforms are being implemented at the necessary speed - which is already reflected in the growth of budget expenditures. This year, due to the inadequate implementation of rationalization, wage expenditures will exceed the budget plan, while a part of expenditures stemming from unreformed state-owned enterprises also accrues (takeover of Petrohemija's debt to NIS of about 100 m Euros). The fiscal risks in the upcoming years, which can already be identified, arise from systematically poor performances of Azotara and MSK (in 2016 alone, they accumulated debt to Srbijagas in the amount of 50-100 m Euros); RTB Bor, which is incapable of fulfilling its current obligations on its own (electricity bill) etc.

A strong decrease in fiscal deficit in 2016 is solely the result of an increased public revenue collection, which is expected to exceed the plan by about 110 bn dinars (900 m Euros). From the beginning of 2016, public revenue collection has been exceeding all expectations, which is why the tax revenue will most likely exceed the plan by about 70 bn dinars and non-tax revenue by more than 40 bn dinars. Our analyses show that one-off payments into the budget constitute the largest part of this non-tax revenue increase in 2016, so it is not very likely that this shall be repeated to a similar degree in the years to come. We would like to emphasize the one-off payment for 4G license (almost 13 bn dinars) and unusually large revenues from dividends from public enterprises (Telekom, Pošta Srbije, EMS, EPS etc) which have exceeded 15 bn dinars in September already. On the other hand, a strong increase in tax revenues almost equally stems from more favorable macroeconomic trends and an indisputable increase in collection efficiency, indicating progress in suppression of grey economy (see Figure 1). This improvement in tax revenue collection should be maintained permanently (or even improved further), but we believe that this would require a comprehensive Tax Administration reform. This is especially due to the indications that a large part of the tax revenue increase in this year was accomplished thanks to targeted *ad hoc* measures implemented by Tax Administration in the field, the effects of which are now probably being exhausted. Maintaining a good revenue collection from 2016 and its additional improvement in the upcoming years is crucially important for continued fiscal consolidation, which is why we believe that modernization and capacity building in the Tax Administration represent an absolute priority for economic policy in the upcoming period.

Figure 1: Efficiency of VAT revenue collection 2006-2016 (C-efficiency)



The savings planned for 2016 will not be realized, and, as some unplanned expenditures appear, public expenditures shall exceed the budget by about 35 bn dinars. The growth of general government expenditures over what was planned can essentially be divided into two segments, which we evaluate differently. The first part comes from acceleration in public investments implementation (which, according to our estimations, could lead to a breach of the annual plan by about 15-20 bn dinars); we see this as an economically, but also even fiscally favorable trend. However, the remaining increase in public expenditures cannot be perceived as positive. This increase comes from the failure to make the planned savings, with a simultaneous appearance of unplanned budget expenditures coming from the unreformed public sector (Petrohemija's debt, perhaps also RTB Bor's debt). The Fiscal Council warned about these risks at the end of last year, in its evaluation of the 2016 Budget, and this has now been shown to be justified. Individually, the most important savings in 2016 were supposed to come from general government downsizing, but it is now definite that its implementation will not even come close to the planned scope. Being that the general government will comprise a significantly larger number of employees at the end of the year than was planned, this will lead to a breach of the budgeted wage bill by about 3-4 bn dinars. Even though the planned savings on salary expenditures in the medium term will not be realized, the inefficient implementation of rationalization will bring about some illusory savings (of about 10 bn dinars) on this item in 2016 - as severance payments have not been made, either.

Not only will the rationalization fail to make the planned savings, it has not been implemented in an adequate and originally planned manner either. According to the budget plan for 2016, the number of general government employees was to be decreased by almost 30,000, but our analyses show that this decrease was significantly lower (about 10,000). Far more important than reaching this (unrealistic) goal is the fact that rationalization was not implemented in the way that it was originally envisaged even on principle, this year as well as in 2015. This relatively modest decrease in the number of general government employees has not come as a part of reform of large government sectors (such as healthcare, education, state administration etc), which would allow for an increase in their efficiency despite the decrease in the number of employees. On the contrary, the basic mechanism of rationalization consisted of a limited replacement of employees retiring, at the rate of 1:5 (one newly employed per 5 retired). This method of rationalization is, in its very nature, random as it is not based on precise analyses on the necessary number and preferred structure of staff in individual institutions and could actually lead to a drop in the quality of public services. Furthermore, it is possible that once the Ordinance on Employment Prohibition is terminated, the vacancies will be filled (in some instances, justifiably so), approximately increasing the number of general government employees back to the previous level - which is something that has already happened in Serbia after the previous attempts to decrease the number of employees in a similar fashion.

Public enterprise reform is mostly avoided, with visible progress being made only in Železnice Srbije. For several years, the Fiscal Council has warned that the poor operation of public enterprises represents the greatest fiscal risk and that the expenditures it imposes on the budget could overturn the initiated fiscal consolidation. However, not a lot has been done in the previous years to improve the performance of public enterprises, and similar practices continued in 2016. *Železnice Srbije* are practically the only public enterprise that has dived seriously into the necessary reforms: it has been divided into four independent enterprises, new subsidy system should increase efficiency, in 2016 alone the number of employees is set to decrease by 15% etc. There are certain delays in the implementation of these measures, but despite this, Železnice Srbije are the public enterprise that has come the farthest with its reforms. On the other hand, substantial reforms of *EPS* have been avoided and delayed for several years, even though the enormous debts of this enterprise that could fall to the budget represent the largest fiscal risk. An additional problem is that investments in the EPS are below the sustainable level, which could impede economic growth in the upcoming years due to a lack of capacities in the energy sector needed to support it. A good illustration of just how unambitious the existing reform plans in the EPS are can be seen when comparing the rationalization plan for 2016 for this enterprise (about 3%, of employees who meet one of the criteria for retirement, with severance payments far above those in the remainder of the public sector) with the aforementioned plan of Železnice Srbije (15%). Finally, it seems that in *Srbijagas*, the old problems are once more re-escalating in 2016. The Fiscal Council has been stating since 2013 that the largest issue with this enterprise is that it is not collecting revenues for the gas delivered to the petrochemical complex (Petrohemija, Azotara, MSK). No solution has been found, so Azotara and MSK have accumulated new debt of about 50-100 m Euros in 2016 alone, which, judging from previous experience, will spill over to the budget sooner or later.

Resolving the status and the reform of enterprises undergoing privatization have not been implemented in 2016, increasing the fiscal risks stemming from their poor performances. In its review of the 2016 budget, the Fiscal Council pointed out that the resolution of the status of enterprises still undergoing privatization is one of the key reform measures in this year, as their poor performance represents an increasing expenditure for the budget. However, except for the sale of Železara Smederevo to the Chinese company HeSteel, serious reforms have not taken place. Although announced, privatizations of PKB and Galenika have not been completed (although these are the enterprises with the highest chances of being sold) and there are no indications of any changes happening in near future in Resavica, Simpo, Lasta and other problematic enterprises. In this group of state-owned enterprises, the largest fiscal risk comes from the poor performance of RTB Bor. There are clear indications that the company is being kept afloat mainly through state aid, by allowing it not to pay for certain current obligations (such as the electricity bill). We believe that the only appropriate thing to do, if the government is to allow such business policies to continue, would be to present this state aid to RTB Bor in a transparent manner, in the expenditures of the 2017 budget. In addition, RTB Bor is not implementing any of the remaining reform measures that had been envisaged in the pre-pack reorganization plan, such as downsizing (by the end of the year, over 400 employees were supposed to leave the company) and management change (planned for second half of 2016). In other words, no substantial changes in operation have been introduced, meaning that the adopted reorganization plan is just an ostensible, and, by all indications, unsustainable solution.

Local government finances are not under control - even though approximately balanced budgets are being formally presented, there are major substantial issues. In a detailed analysis of budget realization for the four largest cities in Serbia (Belgrade, Novi Sad, Niš, Kragujevac), we have observed that Niš and Kragujevac have completely unsustainable budgets and major flaws in the budgeting process. Namely, these two cities have been making their annual expenditure plans based on unrealistic revenue projections for years, which yielded seemingly balanced budgets. However, as only 60-70% of the planned revenue is actually collected, as a rule of thumb, a large share of obligations undertaken is not paid throughout the year and becomes debt in the form of arrears - the payment of which is postponed for the following years. Reports of the State Audit Institution also point out the problem of large, unpaid arrears in some local governments, showing that there are local governments in Serbia whose unpaid obligations reach the amount of their three-year budgets. An additional fiscal problem at the local level of government is poor performance of local public utilities, covered from about 200 m Euros in subsidies (of which over 50 m Euros goes to GSP Beograd, the city transportation company). However, regardless of subsidies, local public utility companies operate with losses and accumulate debt. This overall image has been somewhat improved over the last two years because city heating plants (especially in Belgrade) have been temporarily operating with profit (unusually mild winters, with a sharp drop in the price of gas not accompanied by a drop in the price of heating for end users). Negative consequences of poor business performances of local public utility companies, as well as of insufficient investments of local governments, are not just fiscal. Far more important is the fact that a large part of Serbian population has no access to quality drinking water (Vojvodina), while the sewers infrastructure is not at the level of other European countries.

The most positive trend on the expenditure side of the budget in 2016, clearly standing out, is the more efficient realization of public investments. Public investments in Serbia had been at an unsustainably low level for years back, resulting in a very poor state of infrastructure (as indicated by all relevant international research). Moreover, inefficient implementation of capital expenditures frequently led to the failure of realization of the already relatively modest plans. The Fiscal Council has pointed out, on numerous occasions, that a gradual increase of public investments to the level of over 4% of the GDP (the average in CEE countries) is justified, but also possible - as there is a sufficient number of important infrastructural projects for which favorable funding has been procured. An encouraging step in the direction of a necessary increase in public investments has been made in 2016, being that the realization thus far indicates that capital expenditures could reach 3.2% of the GDP this year instead of the planned 2.8% of GDP. The expected breach of the budget framework of 2.8% of GDP (15-20 bn dinars) is mostly the consequence of higher investments into the road and railroad infrastructure, which is also good. A more detailed analysis of the large road and railroad infrastructure projects, the realization of which is underway (and several that are awaiting realization) has shown us that there is room to continue a similar growth of public investments in the upcoming years. With an increased efficiency of infrastructural projects realization, capital expenditures could be increased to about 4% of GDP in medium term - which is a trend the Fiscal Council wholeheartedly supports.

By decreasing the fiscal deficit to about 2% of GDP conditions have been met for a slow change of the trend of growing public debt to GDP in 2016 already. General government debt in the first nine months has been decreased by over 700 m Euros, from over 25.2 bn Euros at the end of 2015 (76% of GDP) to about 24.5 bn Euros in September (72% of

GDP). This result was supported by a very small fiscal deficit from the beginning of the year (which slowed down the public debt growth, as there was almost no need to fund the current budget expenditures by entering into new debt in this period), but with a substantial contribution from several temporary factors. The public debt was decreased by about 300 m Euros due to favorable exchange rates dynamics, while stronger withdrawal of state deposits allowed for the remaining 400 m Euros decrease. By the end of the year, the fiscal deficit is expected to grow to about 2% of GDP, while state deposits are expected to gradually grow to the initial level, leading to a progressive increase of public debt compared to September, to about 74-75% of GDP. Still, by lowering the deficit to about 2% of GDP in 2016, the main pre-requirement for a change of the growing public debt trend has been met; at the end of the year, the public debt will be about 1-2 pp of GDP lower than last year. Arresting the growth of public debt with regards to GDP was one of the basic quantitative objectives of the initiated fiscal consolidation and it has been met a year earlier than expected. It is important to note that the latest data and projections show a noticeably lower public debt compared to previous assessments, because the Statistical Office of the Republic of Serbia has recently entered a surprisingly large upward correction of the nominal GDP in 2015. As a result, the public debt in that year amounted to 75.9% instead of 77.3% of GDP, which contributed to the public debt in 2016 being significantly lower than originally expected.

Table 1: General government: budget plan for 2016 and expected realization

	Budget plan for 2016	Fiscal Council projections for 2016	Expected deviation from budget plan
in billions of RSD			
I PUBLIC REVENUES	**1711,5**	**1825,5**	**110 higher than planned**
1. Tax revenues	1513	1583	around 70 higher than planned
Personal income tax	149,5	155	around 5 higher than planned
Corporate income tax	64,4	80	around 15 higher than planned
Value added tax	427	451	around 20 higher than planned
Excises	254,3	270	around 15 higher than planned
Excises on petroleum	136	147	
Excises on tobacco	90	95	
Customs	34,8	36	slightly higher than planned
Social contributions	517,4	526	around 10 higher than planned
Other tax revenues	65,5	65	as planned
2. Non-tax revenues	184,2	230	around 40 higher than planned
3. Grants	14,3	12,5	slightly lower than planned
II PUBLIC EXPENDITURES	**1875,0**	**1910,4**	**35-40 higher than planned**
1. Current expenditures	1720,2	1737,4	15-20 higher than planned
Expenditures for employees	432	421	lower than planned by around 10
Goods and services	270,4	274	around 5 higher than planned
Interest payments	144,9	145	as planned
Subsidies	109,6	125	10-15 higher than planned
Social grants and transfers	718,4	717	as planned
of which: Pensions	507,9	506	as planned
Contributions for unemployed persons	18,1	11	around 10 lower than planned
Sick leave	9	10	as planned
Social assistance	154,8	156	as planned/slightly above planned
Other transfers to households	28,6	34	5-10 higher than planned
Other current expenditures	44,9	55,4	5-10 higher than planned
2. Capital expenditures	120,3	135	15-20 higher than planned
3. Activated guarantees	32	34	slightly higher than planned
4. Net lending	2,4	4	slightly higher than planned
III GENERAL GOVERNMENT DEFICIT	**163,5**	**84,9**	**80 lower than planned**