Republic of Serbia
Fiscal Council

FISCAL AND ECONOMIC TRENDS IN 2018 AND STRATEGIC RECOMMENDATIONS FOR 2019 BUDGET

Summary

Budget for 2019 should systematically regulate public finance, improve their structure and support economic growth. Circumstances surrounding the fiscal policy in Serbia have significantly changed in the last four years. At the end of 2014, public finance was in such a state that it presented a serious danger to the macroeconomic stability of the country, threatening to cause a deep economic crisis. The Government was thus forced to implement unpopular measures, such as public sector salary and pension cuts; while changes in Tax Administration management halted the fall in public revenue collection.. Together with Government measures, there was an unexpected and significant external economic stimulus, as Central and Eastern European countries (including Serbia) experienced an extraordinary growth of the economy on the wave of the global drop in gas and oil prices, low interest rates of the European Central Bank and an accelerated recovery of EU economies. Thanks to Government measures and external circumstances, Serbia implemented a successful fiscal consolidation - from a fiscal deficit amounting to 2.2 bn Euros in 2014, we've arrived at a surplus in 2017 and 2018, while the public debt has been decreased from over 70% to under 60% of GDP. Now, with the crisis avoided, the fiscal policy in 2019 and the upcoming years must answer two major and related challenges, remaining after the successful consolidation: *1) improving the structure of public finances and 2) low economic growth.* Having this in mind, in this report, the Fiscal Council presents a detailed analysis of the current economic and fiscal trends, as well as the most prominent structural problems of Serbia's public finance. Based on this analysis, we hereby provide recommendations for the Government, on how to respond to the aforementioned challenges and improve fiscal policy in 2019 and beyond.

In 2019, 400-450 million Euros will be available in the budget for economic growth incentives (*pro-growth* policies) - reduction of the fiscal burden on salaries and public investment increase. Due to many years of low economic growth, Serbia is increasing its lag behind other developing countries of Central and Eastern Europe (CEE). The lower economic growth is also the main obstacle to a quicker increase in living standard in Serbia (including an economically sustainable increase in pensions and public sector salaries). Even in 2018, in which a relatively high GDP growth will be achieved (which we estimate at 4.4%), the situation is not much better. Namely, the significant acceleration of growth in Serbia in 2018 was temporary, under a significant influence of extraordinary factors (such as the strong growth of agricultural production in comparison to 2017, which was marked by drought). Economic trends in Serbia in 2018, with one-off factors excluded, are still markedly weaker than the average in comparable CEE countries. This is why the first major topic we will be covering in this report is: how to accelerate growth in 2019 through fiscal policy and improvement in budget structure. Fiscal Council's analysis shows that in 2019, the budget will contain a fiscal space of 400-450 million Euros that should be directed into the two most

efficient growth-promoting fiscal measures: 1) decrease in fiscal burden on salaries and 2) public investment increase. We propose that one half of the available fiscal space (about 200 million Euros) be funnelled directly towards the economy, i.e. towards increasing its competitiveness - by reducing the average tax burden on salaries from 63 to 60%. The second half of the fiscal space should be used for public investments increase. Public investments don't just stimulate economic growth far more than any other type of public expenditures - they are also truly necessary for Serbia. Quality and development of the basic infrastructure are quite poor, so much so that because of low rate of public investments, Serbia has been at the tail of the CEE ranking list since 2013. To change this, in 2019, significantly larger investments need to (and can) be made into road and railroad infrastructure, as well as into enivronmental protection (wastewater treatment plants, landfills etc), where the many years of neglect have led to a serious threat to human health.

The pension system, and the salary and employment system in the general government need to be permanently regulated in 2019. As we have already noted, the second part of the challenge facing the Government in 2019 and years to come is the fact that Serbian public finances, even with the successfully implemented fiscal consolidation, still have major structural weaknesses - unreformed public enterprises, unsustainable local government budgets, insufficiently efficient Tax Administration, non-reformed education and healthcare systems etc. At that, the two by far the largest and most significant systems in the public sector, the pension system and the general government salary and employment system are currently not properly regulated. These systems were still maintained in the unsustainable, crisis-management regimes for the large part of 2018 (the temporary pension and public sector salary cuts and employment ban were in force) - which now need to be left behind, moving into a system that will be sustainable in the long-term. In the second half of 2018, the Government began taking certain steps to repeal these temporary measures. At the end of September, the Law on Pension and Disability Insurance was amended to terminate the temporary pension cuts, but at the same time, some other - quite debatable - changes were introduced. In addition, new laws are being drafted to bring about permanent (systematic) regulation of the general government salary system. In the second part of this report, we analyse, for the most part, the two major systems of the government and provide recommendations on how they could be regulated in 2019 and beyond, in an economically sound and permanent (systematic) manner.

- As for the pension system, it is good that the crisis management measure to decrease above-average pensions, which was (by definition) temporary, was revoked. The Fiscal Council supports this - we proposed the cancellation of this measure back at the end of last year. What is, however, very bad is the fact that, when the temporary pension cuts were being annulled, the formula for future pension indexation with inflation and economic growth was also deleted, while the new Law gave the Government discretionary power to increase the income of individual groups of pensioners independently of the amount of contributions they had paid in during their career. Such an arbitrary pension system cannot be sustainable and it is not economically just; in addition, it is completely contrary to the basic legacy of the European pension systems that had been established several decades ago. This is why we believe that in 2019 new, systematic and objective rules for calculating all pensions and their annual indexation need to be established.

- Government's efforts in regulating the general government salary system are moving in the right direction, in principle. Two issues were identified and addressed: 1) that it was unjustified to have an arbitrary decision every year on the increase in salaries for the employees of the different parts of the public sector and 2) that it was unjustified to have employees who perform the same (generic) work with the same employer (state) be paid different amounts if they work in different ministries or institutions. However, in the process of regulating the general government salary system, numerous challenges remain. *First*, the range between the lowest and highest salary in the general government must not be too narrow. Pandering to populist demands of the most numerous groups of public sector employees leads to a homogenization of salaries, i.e. it leaves no room for an adequate increase in salaries for the most proficient and most responsible jobs in the government. The market punishes such mistakes quickly and efficiently, as can clearly be seen already through the shortage of medical professionals in healthcare, but also in some other government sectors. *Second*, the unique pay grade system must include (and control) all major general government segments, i.e. the salaries of employees in the military and the police cannot be excluded from the future regulated system. *Third*, a detailed register of employees and their salaries (including all bonuses), comprising all general government jobs must be compiled and published as soon as possible - something that other European countries have done (e.g. Slovenia). *Fourth*, in 2019, the employment ban needs to be lifted in a controlled manner, as there is already a serious shortage of employees in key segments of the general government (healthcare, inspections etc.).

We estimate the fiscal surplus in 2018 to about 35 bn dinars (0.7% of GDP). Fiscal trends in 2018 were mostly favourable, so instead of a planned deficit of 0.6% of GDP, we will achieve a fiscal surplus that we currently estimate at 0.7% of GDP. The better fiscal result comes from an increase in public revenues compared to plan, by about 50 bn dinars, and lower execution of public expenditures, by about 15 bn dinars. The main reason for the increase in public revenue is the somewhat more favourable trend in the labour market (higher than expected growth in employment and average salary). More favourable trends in the labour market were reflected in higher revenue collected from contributions and salary tax, exceeding the plan by about 25 bn dinars. At that, an additional sum of about 20 bn dinars was collected from profit tax, compared to the budget plan, but this is a consequence of overly-conservative planning during the budgeting process at the end of last year and not so much a consequence of major changes in economy profitability (Fiscal Council wrote about this in its assessment of the 2018 budget). On the public expenditure side, the only savings made were those for interests, which will be about 14 bn dinars lower than planned. Interest expenditures are dropping for several reasons: 1) quicker than planned public debt decrease, 2) reduction in interest rates for new government borrowing and 3) appreciation of the dinar in real terms, being that the majority of the public debt comes with interest paid in foreign currency.

Public debt is approaching the safer zone of 50% of GDP, partly due to better fiscal results, but even more prominently, due to a large upward revision of the GDP. By the end of 2018, public debt is likely to drop below 55% of GDP, which is an unexpectedly good result. What is interesting is that the drop in public debt, compared to GDP, is the result of a relatively good fiscal result only to a minor extent. The greatest contribution to the lower share of debt in GDP in 2018 came, actually, from upward revision of the data on nominal GDP, which was performed by the Statistical Office of the Republic of Serbia (SORS) on the 1st of October 2018. With this revision, the SORS determined that Serbian GDP was almost 2.5 bn Euros (6.5%) higher than previously thought and applied this modification to all data from 2015 onward. Since the public debt is now divided by a significantly higher GDP, the share of public debt in GDP automatically dropped, in a single day, by about 4 p.p. - from about 60% of GDP to about 56% of GDP - although there has been no significant debt repayment. By the end of 2018, we expect the share of public debt in GDP to be further lowered below 55% of GDP, due to the budget surplus (no need to take on new loans to cover the deficit) and the government will have paid off some loans from previous years from its deposits. It is important to point out that, due to the large upward revision of the nominal GDP, the share of public debt in GDP will drop below 50% much faster than was previously expected - most probably as early as 2020. For countries like Serbia, this limit is important as it is estimated that below that point, there is no imminent danger of a public debt crisis. Once reached, this will represent an important result in the stabilisation of Serbia's public finance.

The appropriate budget plan for 2019 would comprise a 0.5% of GDP deficit, freeing up 400-450 million Euros for public investments increase and a reduction of tax burden on labour. Fiscal Council's analyses dating back several years showed that for Serbia, the best fiscal objective in the medium term would be to keep the general government deficit at around 0.5% of GDP ("Fiscal trends in 2016, consolidation and reforms 2016-2020", June 2016). Namely, this deficit leads to the necessary drop in the share of public debt in GDP by about 2.5 p.p. per year (assuming moderate economic growth), guarantees the necessary macroeconomic stability, is not excessively restrictive and is in line with EU rules for countries similar to Serbia. Since all these arguments still stand, we believe it would be justified to plan for a deficit of 0.5% of GDP in 2019. Considering public revenue and public expenditure forecasts for the upcoming year (increase in pension and wage bill in the public sector, in line with the forecast nominal GDP growth of about 6.5%, together with a decrease in interest expenditures due to the drop in public debt etc) - we have determined that the fiscal deficit of 0.5% of GDP in 2019 will allow about 400-450 million Euros of fiscal space for the improvement in structure of public finances and to incentivize growth. Two concrete measures to achieve this are the decrease in the fiscal burden on salaries and the increase in the share of public investments in GDP.

We propose that in 2019, the average tax burden on salaries be decreased from 63% to 60%. The most efficient way to translate tax cuts into growth acceleration in the economy is to decrease the fiscal burden on labour. Namely, the wage bill is by far the largest expenditure in production and alleviation on its tax burden directly increases the competitiveness of Serbian economy. A decrease in some other taxes, such as VAT for example, doesn't even come close to such positive effects on the national economy, as it would actually stimulate spending and import. In other words, a decrease in the average fiscal burden on labour from 63 to 60% would represent a fiscal stimulus for domestic production in the amount of about 200 million Euros (which would correspond to the decrease in public revenues). Depending on its preferences, the Government can implement this tax relaxation in several ways. For example, the non-taxable salary base could be increased to about 28,000 dinars, which would have a significant impact on the burden on lowest salaries, compared to best-paid jobs, the expenditures of which would be decreased only marginally. This model would increase the progressiveness of the tax burden on labour and incentivize production and employment in lower value-added jobs (which has a somewhat smaller economic, but somewhat higher social component). The second option is to have a linear decrease in the contributions paid by employers from 17.9% to 16%, which would then relax the burden on all salaries in the country to an equal degree. The Government could also opt for a combination of these two models.

The share of public investments in GDP needs to and can be increased in 2019, to about 4% of GDP. The Fiscal Council emphasized insufficient public investments expenditures as one of the largest fiscal problems in Serbia on several occasions. Public investments are expenditures of the highest "quality", since they have the largest impact on acceleration of economic growth in the short term (engaging the work force in the country, construction materials usually come from domestic producers etc.), but they also have a long-term positive effect on growth as they improve the quality of infrastructure. However, Serbia has been lagging behind other comparable CEE countries in the public investments expenditures for several decades now, which is why the domestic infrastructure is in a much worse state than that in comparable countries. The period from 2013 onward particularly stands out in terms of low public investments expenditures, as these expenditures were decreased to a record-breaking low of just over 2% of GDP. At the same time, the governments of other CEE countries invested twice as much, on average over 4% of GDP. In 2018, certain steps in the right direction have been taken to implement public investments, so after many years, we expect them to return to their habitual pre-2013 level, i.e. to 3.5% of GDP. We believe, however, that it is necessary and possible to continue this trend in 2019, i.e. to increase public investments by an additional 0.5 p.p. to about 4% of GDP, which is the average in CEE countries. Here we would like to draw attention to a technical matter - increase in the share of investments, from 3.5% of GDP to 4% of GDP actually means that they will nominally be increased by over 300 million Euros next year - about 100 million Euros (i.e. growth of about 6.5%, equal to the nominal GDP growth) to maintain the current share in the GDP and an additional 200 million Euros from the available fiscal space. Such an increase in a single year might seem ambitious at first glance, but the Fiscal Council's analyses shows that there are sufficient projects that are already ongoing and credible new plans to implement it. The two main channels that should increase public investments in 2019 are: 1) construction of road and railroad infrastructure and 2) increased investments into environment protection (wastewater treatment plants, shutting down informal landfills and opening new regional centres with waste treatment plants etc). In the upcoming years, after 2019, we estimate that the share of public investments in Serbian GDP should be increased even further, to over 4.5% of GDP to slowly close the gap in infrastructure quality between Serbia and comparable countries.

The largest share of public investments increase in 2019, of over 200 million Euros, should go towards main roads and railroads. By the level of development and quality of road and railroad infrastructure, Serbia is lagging far behind comparable CEE countries (30% fewer highway kilometres per 100,000 inhabitants, the speed of trains below 60 km/h on over one half of the railroads). Constant postponement of deadlines for the completion of Corridor 10, which should be the main road through Serbia, serves as a good illustration of the poor state of affairs in this field (Corridor 10 may not even be finished in 2018). Therefore, the need for greater investments into the road and railroad infrastructure in 2019 is indisputable, the funds are also available, but what could be a problem is their inefficient execution. The Fiscal Council therefore analysed, in detail, what would be the maximum feasible but still realistic increase in these public investments in 2019 - considering the current level of completion of the projects that are already underway and objective deadlines for their completion; we also analysed which specific new projects could start next year (for which there are no technical obstacles to implementation). This analysis has shown that in 2019, public investments into road and railroad infrastructure could be increased by over 200 million Euros compared to 2018 and we'd like to propose to the Government to allocate this amount of funds in the Budget for this purpose (and, of course, to execute it efficiently). In the road infrastructure, the largest share of public investments increase in 2019 would pertain to the acceleration of Corridor 11 construction and to the Belgrade ring-road; and in railroads, to the acceleration of works already begun on the Belgrade-Budapest railroad and commencement of works on electrification and reconstruction of the Niš-Dimitrovgrad railroad.

Investments into environment protection should be increased by over 100 million Euros - for the completion of the projects already underway and for faster preparation of the technical documentation for new projects. Insufficient investments into environmental protection were the subject of a separate study by the Fiscal Council in 2018. The original motive for researching this subject came from the potentially enormous fiscal expenditures for these purposes in the process of EU accession, as investments into environment protection represent one of the most expensive aspects of accession process. However, the analyses we have conducted have shown such devastating results that the accession process had to take a back seat compared to the needs of increased investments for the purposes of protecting the health of the population - which is at serious risk due to many years of environment protection neglect. As a matter of fact, we have not seen such a catastrophic gap in any of the studies we have conducted thus far as we have observed in this field - not just compared to the developed countries of the EU, but also to the comparable Central and Eastern European countries (CEE countries). Drinking water in Serbia (especially in Vojvodina) is of significantly lower quality than that in the comparable countries, almost no landfill meets the sanitary standards - hazardous substances leech from the landfills into surface waters and aquafers; in addition, the landfills are often subject to fires which produce very dangerous gases. In addition, practically all waste water from the sewers is drained into surface waters without any kind of treatment, even in the largest cities (Belgrade, Novi Sad). Finally, the system of air pollution control and reduction is almost entirely non-operational; it is estimated that, at this time, about 2.5 million citizens live in areas with overpolluted air, which comprises at least one pollutant at a level that can be considered hazardous for human health. We therefore propose, for 2019, a start to increased environment protection investments from the national budget (by over 100 million Euros) – out of which one part would be directed to the completion of projects that are already underway (wastewater treatment plants, shutting down informal landfills, completion of regional engineered landfills etc), while the remainder would be directed to a systemic elaboration of technical documentation for as many necessary future projects as possible, to set the foundations for even greater investments into this field in the years to come.

In 2019, the systemic framework for environment protection needs to be improved - meaning a significant increase in both budget and number of staff in the line ministry. Increase in investments into environment by a little over 100 million Euros that we propose for 2019 is not even remotely sufficient to resolve the problems that have accumulated in this field. Actually, public investments into environment protection should be multiplied several times after 2019 (which is why we propose the acceleration in development of project and technical documentation during 2019). However, a systemic framework needs to be put in place, i.e. the capacities of all levels of government need to be strengthened to allow for both the necessary public investments increase, but also for the management and control of this important field. Ministry of Environment Protection alone has a shortage of about 150 staff for the tasks of harmonizing the domestic legislation with EU acquis, control of enforcement and inspection, strategic planning, project management etc. At that, the Environment Protection Agency also needs additional staff and the capacities of local governments need strengthening (which will be a special challenge). Translated into Ministry of Environment Protection budget, we estimate that a sum of about 20 billion dinars should be placed at their disposal in 2019 (compared to about 5 bn in 2018). These funds primarily pertain to the aforementioned public investments increase, but also to the recruitment and training of new staff.

Continuing the employment ban in general government is very dangerous and a controlled exit from this measure should begin in 2019. Employment ban in the general government was introduced as a temporary measure in December 2013, with the original expiration date until the end of 2015. Within this time frame, it was envisaged that the appropriate systemic catalogue of positions should be prepared, based on which there would be reliable data on the number and structure of employees in general government. For the period while the measure remained in force, recruitment was only limited to special cases, and even then, with the approval of the Recruitment Consent Commission - meaning that the overall number of new hires in general government was to be lower than the number of those that retired. Although it was envisaged to last until the end of 2015, employment ban remained in force by the end of 2018 and is likely to be extended into 2019. The Government has not been able to prepare the appropriate job catalogue, without which the termination of the temporary employment ban would lead into unjustified and exaggerated increase in employment in the general government. However, the employment ban was a forced and, in the long-term, harmful measure, which should not have been extended for so long. The government is already facing serious shortage of staff in healthcare, various inspections, parts of ministries charged with managing EU projects (e.g. Ministry of Agriculture), in the aforementioned Ministry of Environment Protection etc. An additional problem is that we have noticed that budget beneficiaries have been increasingly finding ways to evade the existing legislation, which only leads to greater disorder. This is indicated by a steep increase in short-term employment, in temporary and periodic positions and by contract (which were excluded from the ban). The Fiscal Council therefore invites the Government to finally put the system of general government employment in order in 2019, i.e. to define how many employees it needs, of what profile and in which positions. In the meantime, until this is done, we believe that in 2019 it would be justified to use “intervention” recruitment for a certain number of people in those sectors where the need for new staff is obvious and justified. Serbia no longer needs to reduce the total number of employees in general government, so in 2019, the space that is created as the usual 12,000-13,000 employees retire, should be used.