Republic of Serbia

FISCAL COUNCIL December 8, 2017

ASSESSMENT OF THE LAW ON BUDGET FOR 2018

Summary

One of the most important fiscal consolidation objectives - a low fiscal deficit sustainable in the long run - is achieved in the 2018 Budget. The 2018 Budget plans for a 28 bn dinar deficit of the Republic, the largest part of the general government deficit, which is planned at 32 bn dinars. Fiscal Council's assessment of the general characteristics of the budget is mostly favourable. *First*, in terms of the size of the deficit a good fiscal objective has been set (size of the deficit). Expressed as a share of GDP, the planned national deficit amounts to about 0.6% of GDP (of consolidated government, 0.7% of GDP), which is a low enough deficit to decrease the share of the still excessive public debt in GDP by about 2 pp - from about 65% of GDP to about 63% of GDP in 2018. *Secondly*, the proposed budget is credible, i.e. revenue and expenditure forecasts are realistic and it's possible that the budget deficit may even be lower than planned in 2018. *Thirdly*, budget structure is changing for the better, in general - there is a relatively strong increase of expenditures for public investments, tax burden on the economy is decreased (income tax), the total pension bill is appropriately reconciled with the growth of national economy and the wage bill for those employed by the government is still under control, although it would have been far better, in economic terms, if the increase of expenditures for this item in 2018 had been planned at a more modest scale. However, the Fiscal Council, having acknowledged the undisputedly good macroeconomic characteristics of the budget, shall nevertheless devote more attention to its shortcomings in this report, so that they can be corrected in the years to come.

The most prominent weakness of this budget's is the fact that it preserves the temporary fiscal consolidation measures - decrease of above-average pensions and employment ban. The 2018 Budget still has significant shortcomings, of which some have been repeated year in, year out - insufficient transparency, lack of reform measures and failure to adhere to the budget calendar (legal obligation of developing a Fiscal Strategy prior to drafting the budget of the Republic). However, the greatest and most dangerous flaw of the 2018 budget is that it fails to prescribe the termination of temporary budget consolidation measures, adopted at the end of 2014, as an urgent response of the government to an imminent danger of a public debt crisis. These measures were justified at the time and greatly contributed to crisis avoidance, but in the long term, they are economically detrimental and unjust, and could also represent a future fiscal risk, if their exaggerated extension is shown to be legally unfounded. Thus, the Law on Temporary Regulation of Pensions, which greatly reduces above-average pensions, remains in force in 2018. This Law (temporarily) disrupts the economic

relation between the pensions paid out and contributions paid in, which cannot be extended indefinitely. In addition, for the fourth year in a row, general government employment ban is maintained, which, in the long run, has an adverse effect on governance quality (primarily in healthcare, where there already is a shortage of highly qualified staff, but also in other important public sectors). This measure should have been replaced with some other, sustainable solution for the regulation of the number of employees, a long time ago.

The budget for 2018 misses an important opportunity to take a step towards a return to a regulated pension system. The economic regulation of the Serbian pension system was disrupted at the end of 2014 with the adoption of the Law on Temporary Regulation of Pensions. This Law introduced a sharp cut of the above-average pensions, whereas the pensions under 25,000 dinars remained unchanged. In this way, the most vulnerable pensioners were protected in the process of necessary cuts to the public pension bill, but the pensioners with above-average pensions bore a disproportionally high burden of the fiscal adjustment. At present, the imminent danger of a public debt crisis has been avoided, public expenditures for pensions are practically at a level that is sustainable in the long run, at 11% of GDP and there is fiscal room in for a 5% increase of the total expenditures for pensions in 2018. This fiscal space, however, has not been used to return to a regulated pension system in which there is a clear relationship between the amount of pension paid out and the amount of contributions paid in; instead, all available funds have unjustifiably been allocated in a linear fashion - both to those pensioners whose pensions were cut and to those whose weren’t. This can lead to the opening of a legal dilemma, which could prove dangerous for the budget - is the extension of the Law on Temporary Regulation of Pensions in 2018 still being used for the avoidance of a fiscal crisis, or does it now provide for an arbitrary re-distribution of the pensioners’ assets acquired through the payment of contributions? To make matters worse, the budget for 2018 failed to make use of a good opportunity to start its return to a regulated pension system by not causing adverse consequences for any of the pensioners - the Fiscal Council, for example, proposed that all pensions be increased by 2.5% and that the rest of the fiscal space be used to repeal one half of the temporary cut of the above-average pensions.

The budget for 2018 increases expenditures for salaries somewhat more than the economic strength of the country allows. The 2018 budget proposal envisages a salary raise by 10% for the vast majority of the public sector: employees in healthcare, education, Ministry of Interior, Ministry of Defence, Tax Administration etc. Employees in central and local administration get a salary increase of about 5%, while only a small share of employees in the general government have been left without a raise. Although average salaries will be increased, on average, by 9% in 2018, public expenditures for employees will increase by a somewhat smaller percentage, by about 7.5%. Namely, the government is planning to maintain the employment ban, which will reduce the total number of employees (due to retirement), thus reducing the wage bill; in addition, expenditures for staff shall further be decreased due to the planned income tax cut (increase of the non-taxable amount). However, even with these adjustments, the increase of expenditures for employees in general government shall exceed the expected economic growth in 2018, which is not a good thing. This means that in 2018, for the first time in several years, the share of public expenditures for salaries in GDP shall slightly increase (from about 8.2 % of GDP to about 8.3 % of GDP, in line with gross 1 definition), instead of progressing towards its sustainable level of 8 % of GDP. This salary increase that exceeds the national growth rate will perhaps be “masked” by the announced payment of bonuses for employees at the end of 2017 (which will artificially increase the wage bill in 2017), but its existence is undisputed. Another shortcoming is the fact that a significantly higher increase in salaries is planned in the public sector, compared to the private sector (where salaries increase, on average, by 4.5%), in 2018. This is not in line with the Government’s declared commitment to promoting development and attractiveness of the private sector over public sector.

An even larger issue is the fact that the 2018 budget further increases the disorder in the system of salaries and employment in the public sector. The planned increase of salaries in general government somewhat exceeds the economic power of the country and the growth of the private sector. However, this “unearned” increase, even though it sets a dangerous precedent, is still not so large that it would lead to immediate direct fiscal problems. A larger problem lies in the continued poor administration of the sensitive system of salaries and employment in general government, which could have an adverse effect on the quality of public sector services - which, according to the relevant international research, are already scoring very low. Namely, the amounts prescribed in the 2018 budget for salary increases are planned arbitrarily, without any analyses that would show which parts of the public sector warrant a higher and which a lower raise. Due to a disordered salary system, there are already distinct shortages of highly qualified and specific profile staff for the jobs that pay better on the market than in the public sector. On the other hand, certain types of public sector jobs are unjustifiably stimulated by a salary increase. In addition to the disordered salary system, the public sector is additionally disrupted by the maintenance of the employment ban. The example of the healthcare system can serve as an illustration of the impact of employment ban on the quality of public services - there are 2,500 fewer employees in healthcare than is envisaged in the Ordinance on the maximum number of staff (adopted in March 2017). These positions, which the government itself deems necessary, cannot be filled for as long as the employment ban stands. As far back as 2014, the government announced that it would determine the exact number of employees in appropriate positions and then, in line with the findings, let go those who were found to be surplus employees and hire new employees for those positions for which there are shortages. However, instead of finalizing these analyses back in 2015, this will be the fourth year that the management of the number of employees in the public sector rests on the employment ban, even though it was originally prescribed that this temporary and forced measure would only be in force for one year.

The proposed budget of the Republic will have an adverse impact on the local government budgets. A part of the available fiscal space in 2018 has been used for tax relief for the economy, meaning, for the increase of the untaxable share of income - which the Fiscal Council believes to be positive. The problem with this measure, however, is that the dominant share of the income tax (about 70%) is legally the revenue of local governments, and not the central government. Hence, this decision will lead to a loss of about 5bn dinars in revenue for the local governments in 2018. At that, not all local governments will be equally affected by this measure, as the largest relative losses will occur in those cities and municipalities in which a large portion of the employed have low salaries. In addition, an increase of expenditures in the amount of about 5 bn dinars has been imposed on local governments, on the grounds of the legislated increase of salaries in the local administration (5%) and pre-schools (10%). Thus, the decision of the central government has left cities and municipalities with about 10 bn dinars loss in 2018, which is a major blow to their budgets. Bearing in mind that the local budgets are, in the majority of cases, disordered (with major defaults, insufficient investments, catastrophic public utility infrastructure, large subsidies for local public enterprises etc), the Fiscal Council believes that they should not be lead to even more direr straights by decreasing their revenues and increasing their expenditures. We note that some large local governments have initiated programs of fiscal consolidation of their public finances (e.g. Kragujevac and Niš), which could now be jeopardized. We thus believe that the central government would have to increase transfers to the local governments, at least in the amount of 5 bn dinars, i.e. that it would be justified to have the central level (the Republic) bear the burden of the tax cut and not the local budgets.

The budget of 2018 indicates that the Government is giving up on implementing some important public sector reforms. A major problem of the Serbian public sector lies in the - predominantly loss-making state-owned enterprises undergoing privatisation, which still employ about 50,000 people. Resolving the status of these enterprises is something that has been announced for years, but is being implemented very slowly; the budget for 2018 envisages only 2 bn dinars for severance payments to the employees in these enterprises (Transition Fund), which is sufficient to cover the social program for only about 3,000 employees. At that, the proposed 2018 budget maintains the level of subsidies for Resavica, which indicates that another year will pass without the solution of problems with this enterprise. In addition to the regular subsidies for salaries (which, in the last four years, have stabilized at about 4.5 bn dinars), an additional expenditure is planned, once again, for the first stage of closing down a part of the mine in the mine system Resavica, in the amount of 0.6 bn. The same plan was in place in 2017 - which shows that no progress has been made in its implementation. In addition, the budget does not plan for subsidies for some of the largest state-owned loss makers (Azotara, MSK) which probably means that their losses will be funded, implicitly, by Srbijagas again in 2018, as these enterprises are not paying Srbijagas for all the delivered gas.

The envisaged public investment increase is desirable, but does not cover all the areas that need an increase in investments. The budget draft plans for a strong growth in capital expenditures of the central government in 2018, by about 35 bn dinars. Approximately two thirds of this increase pertain to the construction of infrastructure and expropriation (13 + 8 bn dinars), for roads and railroads, as well as to investments into buildings and equipment in judiciary, agriculture, healthcare and education. The largest relative investment increase, however, is planned for the Ministry of Defence with as much as 2,5 times larger budget for capital investments (increase from about 6 to about 15 bn dinars); a similar relative increase is also planned for the Ministry of Interior (from 2.5 to 6 bn dinars). What is specific for these investments is that the purpose of these funds is not completely clarified in the budget. It is understandable that there is a certain confidentiality when it comes to investments into defence and security, but we believe that such a large increase of expenditures from public funds would have to be subjected to parliamentary control, i.e. that the Parliament would have to be acquainted with the purpose and justification for these expenditures. It also remains unknown why armament, military and police equipment have been allocated several times higher budgets when the funds were being distributed, than the investments into education, healthcare or environment protection, which are all fields that are in dire need of investments. In addition, there is another visible trend in budget planning, which is to have an increasing number of investments implemented through bilateral agreements (Belgrade bypass, Preljina - Požega highway, Novi Sad - Subotica railway, wastewater treatment and heat pipeline in Belgrade etc). Such agreements bypassing standard tender procedure can comprise hidden expenditures and have a lower impact on economic growth (greater share of foreign companies involved, imported materials etc).

Macroeconomic assumptions and budget revenue and expenditure forecasts are good, in general, and the GDP growth will probably surpass the forecast. In the final part of the review of the most important notes on the budget, we shall take a brief look at the macroeconomic prognoses and revenue and expenditure forecasts, which perhaps represent the part of the budget proposal of the highest quality. Budget revenues and expenditures, in general, are forecast in a plausible and, in technical terms, excellent manner; when it comes to macroeconomic forecasts, the only significant difference we have compared to the government's forecasts pertains to the GDP growth rate in 2018. The government is estimating the GDP growth very conservatively, at 3.5% while we expect the economic growth in 2018 to reach 4%. Forecasts for trends of other fiscally relevant aggregates (inflation, employment, average salary, dinar exchange rate etc), in general, match our expectations.

GDP growth in 2018 could reach 4% due to positive effects of one-off factors, but it will still lag behind that of comparable countries in structural terms. We estimate economic growth in Serbia in 2017 at a low 1.8%. Poor performance of the economy in 2017 was affected by certain one-off factors - drought and a major decline in production in EPS at the beginning of the year, due to poor management of the company. Had it not been for these factors, the GDP growth would have amounted to 2.8% and that would be the realistic trend of economic activity in Serbia in 2017, going into 2018. Therefore, even if it hadn't been for those extraordinary factors, the planned growth rate of 3% in 2017, which the government forecast at the end of 2016 - and which the Fiscal Council judged to be moderately optimistic at the time - would not have been achieved. In 2018, we expect a basic trend of GDP growth similar to that of 2017, but with extraordinary factors shifting sides. The expected recovery of agriculture following a drought and establishment of the usual level of electricity production following a steep drop in the first half of 2017 should accelerate GDP growth by about 1.1%, i.e. lead to a temporary GDP growth of about 4%. Therefore, in 2018, a 4% growth would mean a simple continuation of the current economic trends with a positive contribution from one-off factors, while the forecast rate of 3.5% that the government has presented would actually represent a poor achievement, as it would mean a deceleration of the current economic activity trend. It is important to point out that, with its basic GDP growth trend of about 3%, Serbia is still among the countries with the lowest growth in the entire Central and Eastern Europe, as the average economic growth of comparable countries in 2017 amounted to 4.5%.

Revenues of the central budget for 2018 have been forecast well, i.e. they match the expected macroeconomic trends. Total revenues and income in the 2018 budget are planned at 1,178.5 bn dinars and are slightly, by about 20 bn dinars, higher than those estimated to have been achieved in 2017. Such a forecast for budget revenues in the upcoming year is a consequence of the growth of tax revenues and donations (by over 25 bn), decrease in non-tax revenues (by about 15 bn) as well as a planned increase of own revenues of indirect budget beneficiaries (by about 10 bn). Tax revenue growth is justified by the expected macroeconomic trends - economic growth, inflation and increase in employment and salaries. There is a chance that the tax revenues could somewhat exceed the plan, since the analyses of the Fiscal Council show that the tax base growth in 2018 could be higher than the official forecasts in the budget. We emphasize, however, that such a conservative budgeting of tax revenues constitutes a good budget practice, as macroeconomic trends are difficult to forecast precisely, so it is better that during the year there are potential additional reserves than to have the budget face a shortage of funds compared to the Law on Budget. Decrease of non-tax revenues has also been planned well, as 2017 was marked by large one-off payments into the budget, coming from the NBS's profit, payment of the Deposit Insurance Agency (DIA) and other payments, which cannot be counted on every year.

Budget expenditures have mostly been forecast objectively and it is possible that the budget expenditures come somewhat below the plan at the end of the year. Budget for 2018 plans for central level expenditures at 1,207 bn dinars, i.e. for a growth in expenditures by about 70 bn dinars (about 6.5%) compared to their estimated realisation in 2017. In budget expenditures as well, two divergent trends can be seen. On one hand, there is an increase in public investments, salaries and pensions as well as other current expenditures, procurement of goods and services and subsidies. Total increase of these expenditures has been forecast at about 90 bn dinars. On the other hand, net budget loans which were extraordinarily high in 2017 are decreased, while interests and guarantees are declining due to the decrease of public debt and completion of payment of certain guaranteed loans of public and state-owned enterprises. It has been planned that these expenditures would decrease in the total amount of about 20 bn dinars compared to 2017 Budget expenditures have mostly been forecast objectively and it is possible that they will come somewhat below the plan at the end of the year. In particular, funds planned for interests and pensions will probably not be used in the planned amount, which could lower the overall expenditures of the Republic in 2018 below the planned 15-20 bn dinars mark. On the other hand, certain expenditures - primarily severance payments for employees in the unprivatized enterprises and fines and penalties - could exceed the yearly targets in the total amount of about 10 bn dinars. The net result of these tendencies could mean lower expenditures compared to the plan, by about 10 bn dinars. Savings compared to the budget plan could end up being even larger if the inefficient implementation of public investments were to continue in 2018, but it would not be economically favourable.

Even with the achievement of a sustainable level of fiscal deficit, Serbian public finances are still far from being sound - which is something to bear in mind when adopting the budget. The low fiscal deficit achieved, based on which the Budget Proposal for 2018 has been drafted, marks a great and indisputable success of fiscal consolidation begun at the end of 2014. In the previous three years, the Government managed to decrease the annual national deficit by 2.2 bn Euros, or from 6.6 % of GDP to about 0.5 % of GDP, through consolidation measures and strong increase in public revenue collection. However, an almost balanced budget, important as it may be, is not the only measure of success of a fiscal policy. Serbia's public debt is still too high; there are still enormous problems in the operation of public and state-owned enterprises, local budgets are disordered, public services quality is very low (healthcare, education, administration) and the many years of shortages in investment into national and local infrastructure are having a devastating effect on the environment and quality of life of Serbian population (access to clean drinking water, sewers, waste treatment, wastewater treatment etc). For all these reasons, the Fiscal Council is calling for responsible fiscal policy and avoidance of adopting populist measures which, in addition to their short-term benefits, have an adverse impact on the quality of life of the citizens, in 2018 and the years to come.