Republic of Serbia

FISCAL COUNCIL
28 November 2018

Assessment of the Budget Proposal for 2019

Summary

The 2019 budget plans for a good (low) fiscal deficit; its structure, however, is not satisfactory form the economic point of view. The 2019 budget plans for the central government deficit of 23 bn dinars, which, at the same time, is the dominant share in the general government deficit planned at 29 bn dinars (0.5% of GDP). The envisaged low fiscal deficit is suitable for Serbia, since it secures the achieved macroeconomic stability (low inflation, stable dinar exchange rate etc.); it will also lead, in the upcoming year, to a further decrease of the high public debt share in GDP by about 2.5 p.p. - from the current 54% of GDP to approximately 51.5% of GDP at the end of 2019. The second strength of the proposed budget is that it is credible, i.e. in general government revenues and expenditures are planned realistically and there is no prominent risk of the deficit exceeding the plan (which had been a common occurrence up to a few years back). Not underestimating the importance of the aforementioned strengths of the proposed budget, we still emphasize that these are built on the legacy from previous years - Serbia's had a fairly balanced budget since 2017, and credible (often even justifiably more conservative) forecasts of public revenue and public expenditure were, in most cases, a feature of all adopted budgets since 2015, when Serbia entered into arrangements with the IMF. The issue with the proposed 2019 budget is that it lacks important public finance improvements: 1) insufficient investments planed for infrastructure development (roads, railroads, environmental protection); 2) the general government salary and employment system reform has been abandoned, so salary increases in different government sectors have once again been arbitrarily determined; at that, the harmful employment ban has been prolonged; and 3) no improvement in the budget process and violations of the budget calendar during the preparation of the budget. The Fiscal Council provided detailed and concrete recommendations for all the above (and some additional) improvements in Serbian public finance, at the end of 2017 and during 2018, over several reports - but even so, the measures have not been implemented.

The proposed 2019 budget is not sufficiently pro-growth oriented. After the successfully implemented fiscal consolidation between 2015 and 2017 averted a public debt crisis and ensured macroeconomic stability, the next major economic problem that the government should be tackling is insufficient economic growth. For a number of years, Serbia has been lagging behind in economic growth compared to other comparable Central and Eastern European (CEE) countries. Cumulative GDP growth in Serbia in the previous five years (including the estimated growth in 2018 by over 4%) is about 10%, while the comparable CEE countries have, in the same period, achieved a GDP growth of 20% on average. Serbia's lag continues in 2018, despite the fact that the growth will reach CEE average, amounting to a little over 4% - since about 1 p.p. of the achieved GDP growth is owed to a temporary

agricultural recovery following the 2017 drought. The long-lasting comparably low growth is the main reason why the gap in living standards between Serbia and the countries in the region (Romania, Bulgaria, Hungary etc) has expanded. Bearing this in mind, the Fiscal Council recommended, in its report from October 2018 (“Fiscal and economic trends in 2018 and strategic recommendations for the 2019 budget”), that the Government improve the budget structure in 2019 by allocating more funds within the available fiscal space for effective growth incentives (*pro-growth* policies). In more concrete terms: to decrease fiscal burden on salaries from 63 to 60% and increase investments in infrastructure development by about 300 m Euros. The Government, however, implemented only a small fraction of these recommendations. The 2019 budget envisages a minute decrease of the fiscal burden on labour, from 63 to 62% (and some smaller and more targeted tax incentives), while the planned infrastructure investments are increased by less than 100 m Euros, instead of by 300 m. Therefore, the Government has opted to use the available funds in 2019 for other priorities - primarily for a large increase in expenditures for the procurement of equipment for the military and the police, for a greater increase in expenditures for general government wage bill than is economically justified and for some other individual uses.

Even though the Budget Proposal seems to show a large increase in capital investments - this increase primarily pertains to the purchase of equipment for the military and the police. Capital expenditures of the national budget in 2019 are planned at about 165 bn dinars (1.4 bn Euros) which is a significant increase compared to the 2018 budget with its 127 bn dinars for capital expenditures. However, the largest share of this increase in 2019 pertains to the procurement of military and police equipment, which was planned at the level of 21 bn dinars in 2018, while 46 bn dinars are to be allocated for this purpose in the 2019 budget. In fact, procurement of military and police equipment in 2018 exceeds the budget plan - over 30 m dinars will have been spent for these purposes in 2018 instead of the planned 21 bn dinars, which is the main reason why 2018 capital expenditures will come in slightly above the plan (and not from going above and beyond the plan for the road and railroad infrastructure development). What is specific for investments into arms and other military and police equipment is that the purpose of these funds has not been completely listed in the budget. Although it is understandable that there is a certain confidentiality of this type of investments, we believe that their quadrupling in only two years’ time would have to pass through some form of parliamentary control. According to the budget plan for 2019, investments into military and police will reach almost a third of all capital investments at the central level and a fifth of overall capital investments of the general government (including local governments, PE “Roads of Serbia” etc.). This is why it would be good to have the National Assembly informed, in as much detail as possible, on the purpose and justification of these expenditures, i.e. why has defence and security been allocated several times more funds than, e.g. investments into education, healthcare and environmental protection - areas where investments are indisputably necessary - during the budget re-allocation.

The main economic issue with the 2019 budget is that it does not plan for a sufficient growth in infrastructure investments. The state of the road and railroad infrastructure in Serbia is extremely poor (compared to the CEE countries, 30% fewer motorway kilometres per 100,000 population; on over a half of the railroads, train speeds do not exceed 60 km/h etc.) At that, Serbia is among the most polluted countries in Europe - with no wastewater treatment plants even in the largest cities, almost no properly engineered landfills, with many settlements in Serbia failing to provide safe drinking water and approximately 2.5 million citizens living in areas with overly polluted air, representing a hazard to health. Finally, the government’s investments into education and healthcare have been under a half of what comparable CEE countries allocate for these purposes for years. In addition to improving the quality of life of the population, increased investments in infrastructure have a significant impact on economic growth. It is the most efficient public policy to spur GDP growth in the short-term, while the works are underway (labour, production of construction materials), but also in the medium term (improvement of the quality of infrastructure used by the economy). However, despite the indisputable needs, the 2019 budget does not plan for a sufficient increase in expenditures for these purposes. The planned investment increase of less than 100 m Euros is sufficient to keep the share of infrastructure investments in the GDP at approximately the same level in 2019 (i.e. failing to improve the budget structure). Even more specifically, compared to 2018 expenditures, infrastructure investments grow only in the land expropriation segment (8 bn dinars), while the value of physical works on the construction of roads remains the same, since some projects are nearing completion while others commence or intensify. Furthermore, investments into the Ministry of Education and Ministry of Health are even decreased by a billion dinars, although it is possible that this decrease will be compensated by the increase of investments from the Office for Public Investments Management with over 2 bn dinars (mostly financing construction and reconstruction of schools and hospitals). Finally, an increase of investments by a mere 1 bn dinars is planned for environment protection; perhaps the best illustration to show how little this is comes from the Fiscal Council's analysis (October report) showing that this field would require an increase of investments by about 14 bn dinars in 2019 (and that such an increase is possible).

The 2019 budget plans for a larger growth of average net salaries than is economically justified. The 2019 budget plans a salary increase of 12% for nurses and medical technicians; 10% for medical doctors; 9% for the Ministry of Interior, SIA, Ministry of Defence, social protection institutions and education; 8.5% for the Tax and Customs Administrations; and 7% for other budget beneficiaries. These increases mean that the general government salaries will grow, on average, by 9% in 2019, which is too high a growth. The first issue is the fact that in 2019, the 2018 situation will be repeated - the salaries of general government employees will grow almost twice as fast as the salaries of employees in the private sector. Namely, general government salaries grew, on average, by 9% in 2018 while at the same time, the raise in the private sector amounted to about 5%. Preservation of this trend, which is practically planned in the proposed budget for 2019, is not economically justified since public sector salaries already are significantly higher than the more productive private sector (even considering the higher educational structure of public sector employment), while general government employees, at that, also enjoy a higher level of job security. Finally, such increases of general government salaries also contradict the declared commitment of the Government and frequent statements of state officials that they primarily aim to encourage the development and attractiveness of employment in the private sector, not the public sector.

The proposed salary increase comes with two bad measures - extension of the temporary employment ban and transfer of a part of fiscal relaxation of labour burden onto the growth of net general government salaries. Although the salaries of general government employees will be increased by about 9% in 2018, the overall general government wage bill expenditures will still increase by a somewhat smaller percentage, about 7.5%. This is because: 1) In 2019, the general government will maintain the employment ban, decreasing the number of general government employees (due to retirements) and thus decreasing the wage bill and 2) the elimination of unemployment contributions paid by the employer (in this case, the government) will also decrease the wage bill, which means that the net salaries in the general government will increase at a slightly higher rate than the overall, gross budget expenditures for them. A more detailed assessment and impact of these two measures on expenditures for the wage bill will be explained at the end of this paragraph, but here we would like to emphasize that, even with the aforementioned mechanisms allowing the average net salary increase in general government by 9% to have a somewhat smaller effect on budget expenditures for the wage bill (7.5%) - even the said 7.5% are still somewhat higher than justified. The nominal GDP growth in 2019 is forecast at 6.9%, meaning that, in 2019, the government will be increasing expenditures for the wage bill in general government faster than the economy grows to support them through taxes.

- Extension of the general government employment ban in 2019 is very dangerous and the Fiscal Council has already written about this in detail several times. In short, employment ban in the general government was introduced as a temporary measure in December 2013, with the expiration date at the end of 2015. Within this time frame, it was envisaged that the appropriate jobs systematization should be prepared, based on which there would be reliable data on the number and structure of employees in general government. However, since the Government has still not done this, employment control in 2019 will be implemented through the general employment ban (using the Committee for New Employment Approval for the most critical cases). This practically means that the major issue of a shortage of staff in health care, different inspections, parts of Ministries charged with EU project management etc. will not be tackled in 2019, either. On the other hand, the Government has freed up additional space for a salary increase by extending this (harmful) measure - as the decrease of expenditures for the wage bill arising from the natural, and thus non-selective retirement has not been funnelled into savings, but has rather been used for an additional 1 p.p. increase of salaries for those who remain employed.
- Similarly, the planned elimination of unemployment contributions paid by the employer is practically used for a greater growth of net salaries in general government - which is not economically justified. Namely, the motive for the decrease of fiscal burden on labour was to reduce the burden on the private sector, spurring economic growth. The Government, however, used this measure for an additional increase of net salaries in general government, by the amount by which the gross expenditures for their wages have been decreased as the unemployment contribution paid by the employer was abolished. From a different viewpoint, the Government could have decreased the contributions rate for the economy by a higher percentage, had it not directed a part of this space to an increased growth of net general government salaries.

The most prominent issue with the planned salary increase in 2019 is certainly the fact that a reform and regulation of the general government salary system has been abandoned. Although only a month prior to the adoption of the Draft Budget the Government issued firm assurances, that it will regulate the general government salary system in a systemic manner and introduce a single and fair pay grade system - this was abandoned in the end. Salary increase percentages for 2019, were determined by individual ministries, as was the case in previous years as well, at the discretion of the Government, with no clear economic criteria. This approach is deeply flawed. The Fiscal Council's analysis from June 2018, which clearly showed that salaries in the Ministry of Interior (MoI) were too high compared to other civil servants, can be used a good illustration of this point. Hence it is still unclear what were the criteria that the Government used to decide to increase salaries of the MoI employees by a larger percentage in 2019 than, for instance, the salaries of Ministry of Agriculture employees. In addition, this classification of employees by ministries leads to salaries of employees performing, essentially, the same tasks (e. g. administrative workers) with the same employer (government) being increased to different levels because these employees work in different ministries. In other words, completely contrary to its announcements, the Government opted for an *ad hoc* increase in salaries in the 2019 budget, additionally increasing the disorder in the public sector salary system.

The Fiscal Council hereby invites the Government to finally regulate the salary system in the general government in 2019 in a systemic and lasting manner. The process of regulating the general government salary system has been going on for four years now, with no concrete results - in fact, in the meantime, the general government salary system has been additionally set back by *ad hoc* salary increases by individual ministries, which have been implemented since 2016. We thus believe that 2019 is the ultimate deadline to finally find a lasting systemic solution, like those in European countries (or, to admit the lack of political will for a consistent implementation of this reform). In order to regulate the general government salary system in a systemic and fair way, the Government must first change the approach to this issue it has taken so far. Specifically, clear and concrete criteria that would make this reform sensible in the first place, must finally be applied in a consistent manner - which had not been the case until now. *Firstly*, the pay grade must apply to the entire civil service sector. The practice so far that saw the adoption of individual laws for different segments of the civil service sector and postponement of inclusion of the police, army and some other parts of the public sector in the unique pay grade system, jeopardizes the integrity and the purposefulness of the reform process. *Secondly*, the salary base in the civil service sector needs to be matched to the minimal wage at the national level. This will avoid meaningless pay grade coefficients leading to salaries lower than the minimal wage guaranteed by law. *Thirdly*, salary parity for different jobs in the general government must be determined according to economic (and market) parameters and not according to the political strength of individual public sectors and their unions. As a consequence of the populist, non-market general government salary system management thus far, we have the following illogical situation: on one hand, public expenditures for the wage bill are considerably high (average salaries in the Serbian public sector are significantly higher than in the private sector), while, on the other hand, the most qualified and most needed staff are leaving the public sector as they can get far better conditions for work if they move into the private sector. Relating to that, the range between the lowest and highest salary in the public sector could increase from the current 1:7.5 to 1:12 (as is the case in European countries). *Fourth*, 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 (e.g. Slovenia).

Revoking one half of the temporary salary freeze in public enterprises is generally justified, but it does not apply to EPS. In the majority of public enterprises that the Fiscal Council analysed, the Government's decision from November 2014 to temporarily cut net salaries by 10% was consistently implemented. Thus, in four major public enterprises (Pošte Srbije, Telekom, Srbijagas and EMS), net salaries are still significantly lower than they were in 2014. In these cases, it is justified to lift one half of the salary cut, i.e. to increase net salaries by 5% in 2019, since the immediate danger of a fiscal crisis has passed. However, our analysis for the (by far) largest public enterprise in Serbia - EPS - shows that the net salaries in this enterprise had not been decreased in 2014 at all, i.e. that the salaries even continued to increase in 2015 and the following years. More specifically, average net salaries in EPS have been increased from 79.5 thousand dinars in 2014 to over 84 thousand dinars in 2017 (latest available data), although they were supposed to be decreased below 73 thousand dinars in 2015 and remain at approximately that level in the following years. To make matters worse, as the salaries of EPS employees were being unjustifiably increased, this enterprise failed to make sufficient investments (EPS investments were lower than depreciation, meaning that the enterprise was lowering its production capacities instead of increasing them through investment), while its performance issues in 2017 had a visible impact on the economic growth of the entire country. Due to the above, the Fiscal Council believes that it is not justified to further increase the salaries of EPS employees in 2019 by revoking the temporary Government measures, but rather to use these funds to increase investments of this enterprise. The EPS employees have already enjoyed sufficient privileges to have their salaries increased at a time when the remainder of public sector wages (education, health care, other public enterprises) and pensions were cut.

In 2019, objective rules for reconciling pension growth with clear economic parameters need to be reintroduced. A year ago, when assessing the draft budget for 2018, one of the main objections of the Fiscal Council was the fact that the temporary cut of the above-average pensions had not been repealed in the 2018 budget. The National Assembly corrected this mistake, with a delay, at the end of September 2018 when the temporary pension cut was finally suspended. However, at the same time, the formula for future indexation of pensions in line with inflation and, in part, growth rate was also unnecessarily cancelled, while other legislative changes were also implemented to give discretionary rights to the Government to increase pensions of individual groups of pensioners regardless of the contributions paid during their years of service. 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, the contested amendments to the Law on Pension and Disability Insurance (PDI) need to be revoked and new, systematic and objective rules for calculating all pensions and their annual indexation need to be established.

The 2019 budget plans for a decrease of fiscal burden on labour from 63 to 62%, which is a step in the right direction, but the relaxation could have been even larger. From 2019, the unemployment contribution paid by the employer will be eliminated (0.75% of gross salary), resulting in an overall decrease of fiscal burden on labour from 63 to 62%. The decrease of fiscal burden on labour is generally an efficient and well targeted pro-growth policy. 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 imports. In other words, abolishment of the unemployment contribution paid by the employer is a direct and fair fiscal incentive to domestic production in the amount of about 75 m Euros, which the Fiscal Council certainly supports. The only objection is to the level of this incentive, as it is insufficient to lead to a detectable decrease in wage bill expenditure for businesses. Fiscal Council's analyses show that it was possible to have at least three times larger fiscal relaxation on labour in 2019 (from 63 to 60%), had the Government opted for a smaller increase of general government salaries and given up on some other partial tax incentives - and had there not been for the extremely large (and non-transparent) increase of expenditures for the army and the police. It is always important to emphasize these analyses as they show that a conservative, rational budget does not automatically mean a lower tax burden for the economy and citizens.

Public revenues and public expenditures have been planned credibly in the 2019 budget, in general, and the fiscal deficit could prove to be somewhat smaller than planned. The 2019 budget continues the good practice established several years back, of having mostly realistic (or conservative) plans for public revenues and public expenditures. The 2019 budget plans for an overall increase in public revenues by about 2.2% or by about 25 bn dinars compared to the estimated implementation in 2018. A somewhat lower public revenues increase than the forecasted growth in 2019 is the consequence of a decrease in non-tax revenues (excluding certain one-offs that were collected on in 2018 and cancelling half of the salary freeze in public enterprises, which was registered as a non-tax revenue for the national budget). Tax revenues are planned approximately in line with the estimated tax base growth, which amounts to a little over 5%. The Fiscal Council estimates that the public revenue collection will, most likely, come close to the planned amount. On one hand, VAT collection has been somewhat more ambitiously planned, but some other revenue items on the budget have been forecast rather conservatively, so it would not be surprising to see a greater collection on non-tax revenue than planned (which was common practice in the previous years). On the public expenditure side, their growth has been planned at about 75 bn dinars (6.5%). The largest share in this increase is the increase of the wage bill and capital investments (military and police equipment, etc). On the other hand, interest expenditures and expenditures for the payment of guaranteed debt of public enterprises are decreased, with the decrease of public debt and repayment of the largest share of the guaranteed Srbijagas's debt. Public expenditures were planned, in general, conservatively, especially when it comes to interest and pension expenditures, so it is likely that the execution of this segment will come in slightly below the plan (except if the Government changes its policies in 2019 and introduces some new expenditures). Considering all of the above, barring any changes in the planned Government policies in 2019, the fiscal deficit is expected to come in slightly under the plan, but very slightly. It is almost certain that the situation from 2017 and 2018, when the fiscal result exceeded the forecast by over 50 bn dinars, will not repeat in 2019.

The budgeting process is still being disrupted - the annual financial statement is not being adopted and the budget calendar is not being respected. In the last few years, the Government focused on public finance consolidation, but with the successful fiscal deficit elimination, the conditions have now been met to direct its capacities at improving the budgeting process in Serbia. It is indisputably necessary, in order to use the public funds for purposes that will most benefit the society, as well as to ensure transparent and accountable management of taxpayer's funds. This is why we would like to stress, yet again, that it is necessary to insist on a consistent implementation of the budget calendar from the very beginning of next year, on adoption of a Fiscal Strategy within the prescribed deadlines (to allow for timely identification of medium-term budget priorities), to continue working on extending the scope of public funds execution monitored in the Treasury Administration and to finally establish a functional and comprehensive register of civil sector employees. In addition, accountable and transparent public funds management encompasses the final termination of the practice of not adopting the laws on annual financial statement (none have been adopted by Parliament since 2002, and since 2014, the Government stopped even submitting the Bills for this important law to the Parliament). For years, the public has had no information on how the funds, planned in the budget, had actually been used.