Republic of Serbia
FISCAL COUNCIL

ASSESSMENT OF THE DRAFT LAW ON BUDGET FOR 2017

Summary

The Budget of the Republic of Serbia for 2017 brings improvements to the public finances of Serbia, but misses out on an opportunity to take a larger step towards their lasting recovery. Public finances of Serbia are still not satisfactory. The public debt of about 74% of GDP is very high and dangerous; unsuccessful public and state-owned enterprises represent an enormous expenditure for the budget, but also a future fiscal risk. In addition, there are numerous other structural problems with public finances reflected in excessive current expenditures and low public investments, incomplete budget transparency, frequent takeover of unplanned expenditures, unsustainable position of a large number of local governments and others. The proposed Law on Budget for 2017 diminishes some of these problems. *Firstly,* a relatively low deficit of 69 bn dinars (1.6% of GDP) will lead to a slight decrease of public debt compared to GDP in 2017, by about 1 pp. *Secondly,* the deficit has been credibly planned, i.e. there are no great risks that the revenue side will come in significantly lower than was planned, nor that the expenditure side will spiral out of control. *Thirdly*, the budget of the Republic of Serbia now includes large infrastructural projects, which were previously formally kept out of the budget (which frequently caused confusion among the public about the true size of fiscal deficit). Even though all these are undisputed and important improvements that the Fiscal Council supports, they are still not sufficient. Namely, even with the expected reduction, the share of public debt in the GDP will amount to a high and unsustainable 73% - meaning that the deficit would have to be additionally decreased in the years to come. One of the reasons why the budget plan is more plausible than in the previous years is the fact that it calls for no great savings compared to 2016 (which will end with a similar deficit to the one planned for 2017). Finally, we believe that the budget expenditures should encompass current costs caused by poor business performance of public and state-owned enterprises, instead of, as was the practice in all previous years, taking over their old debt without previous planning (Petrohemija 2016, Srbijagas 2015, JAT 2014). Including these expenditures into the budget at the time they are created would demonstrate clearly and in a timely manner just what these companies cost the budget; the need for their reform, privatization or bankruptcy would be better recognized, lowering future budget impact and risk.

The Budget of the Republic of Serbia plans for a 69 bn dinar deficit (1.6% of GDP), which is now approximately equal to the overall general government deficit (75 million dinars, 1.7% of GDP). Law on Budget for 2017 introduces a significant and positive methodological change - large infrastructural projects (construction of Corridors 10 and 11) are now integrated into the Budget, making it more comprehensive and more transparent. Up to now, these expenditures were added to the deficit of the Republic of Serbia at a later date, as "project loans" and capital expenditure of Corridors of Serbia. This is why the deficit of the “core” state budget (of the Republic) was significantly smaller than the general (consolidated) government deficit - which lead to a certain confusion among the public with regards to the actual extent of fiscal deficit. Large infrastructural projects are a natural part of the state

budget, as they are financed from loans taken - and repaid - by the Republic of Serbia, and line ministries take part in their planning and monitoring. This is why the Fiscal Council regularly emphasized the need for these expenditures to be included in the republic budget in its previous reports. By including large infrastructural projects, the deficit of the Republic in 2017 becomes almost identical to the general government deficit (Table 1). We would also like to note that this methodological change makes it more difficult to compare the new state budget to the previous budgets – e.g. because the previous budget did not encompass the construction of the Corridors, capital expenditures for 2017 shows an enormous growth in comparison to 2016. Taking into account the change in methodology, it can be seen that the capital expenditures in 2017 have been increased only slightly when compared to 2016.

Table 1: Planned general government deficit in 2017 by levels of government

	bn RSD	m EUR	% of GDP
The Republic (Law on Budget)	-69,1	-555,0	-1,6
Local governments	0,0	0,0	0,0
Cities and Municipalities	2,6	20,9	0,1
AP Vojvodina	-2,6	-20,9	-0,1
PUC "Roads of Serbia"	-6,1	-49,0	-0,1
Social insurance funds PIO, RFZO, NSZ, SOVO*	0,0	0,0	0,0
General government	**-75,2**	**-604,0**	**-1,7**

Source: Fiscal Strategy for 2017 with projections for 2018 and 2019.

* The mandatory social insurance Funds are formally balanced, through transfers from the budget of the Republic that cover all of the funds they are missing for their operation (about 230 bn dinars)

The planned deficit for 2017 is approximately at the same level as the expected deficit in 2016 - the budget does not plan for significant savings. Public revenue and public expenditure trends in the first ten months of 2016 indicate that the deficit of the Republic of Serbia (inclusive of project loans) will amount to about 2% of GDP in 2016. However, this deficit also includes an unplanned payment of old Petrohemija's debts and a one-off payment of 5,000 dinars to each pensioner. Without these one-off expenditures, the deficit in 2016 would have been a little over 1.5% of GDP, i.e. almost identical to the one planned for 2017. This means that the 2017 budget is actually not planning for any new considerable savings - the most prominent measure for further deficit decrease is relatively small (about 5 bn dinars) and pertains to the adoption of amendments to the Law on Local Government Funding. Apart from this, there are no other significant measures, which were common in the previous budgets, such as decrease in certain subsidies, increase in excise; in addition, the budget no longer plans for a strong downsizing (which has not been implemented as planned in the previous years, either). In simple terms, due to the expected economic growth in 2017, revenues of the state budget are planned at an increased level of about 10-15 bn dinars, compared to what was realized in 2016, which will be spent on higher expenditures for salaries and pensions, while the remaining items on the expenditure side will be similar to what was realized this year. Due the fact that new state budget compared to what was achieved in 2016 does not bring significant change either in the level of deficit or in structure and level of public expenditures, the Fiscal Council is of the opinion that the budget could perhaps have been somewhat more ambitious, even with the undisputed improvements in mind.

The budget plan for 2017 is credible - no great risks on either the revenue or the expenditure side. In analyzing budget risks for 2017, we will look once again to 2016. Namely, the budget plan for 2016 called for significant structural savings of about 0.7% of

GDP, which rested, to a large extent, on rationalization (planned savings of 0.35% of GDP, equivalent to a downsizing of 29,000). When the Fiscal Council was evaluating the budget for 2016, it was this item that was emphasized as the largest risk. In the end, savings from downsizing have not even close been materialised, but the overall deficit has been decreased even more than was planned, due to extraordinary and unexpectedly successful public revenue collection rate. Unlike the budget for 2016, the new budget has no such insufficiently plausible measures, as it practically does not plan for any further deficit decrease compared to what was achieved in 2016. Still, it is very good that this time both the revenue and the expenditure sides of the budget have been realistically planned and the risks we have observed (primarily pertaining to insufficient subsidies for RTB Bor and a possible breach of budget for the Ministry of Education) are not balance sheet important.

Repayment of old debt of public and state-owned enterprises comprises the largest part of the planned deficit for 2017. The Fiscal Council regularly emphasizes that the problems of unreformed public and state-owned enterprises represent a heavy burden on Serbian public finances and that the resolution of this situation must be set as a priority. Otherwise, the budget expenditures going to these enterprises will "eat up" other savings that have been achieved, leaving the public finances vulnerable to any external shock. Just how significant and dangerous this burden is can be seen from the 2017 budget, where more than half of the deficit pertains to expenditures originating from these enterprises. These are mostly expenditures stemming from called guarantees for loans that public and state-owned enterprises took out until 2015, which are now maturing. Overall, these expenditures amount to about 40 bn dinars in 2017 (0.9% of GDP) while the deficit of the entire national budget has been planned at the level of 69 bn dinars (1.6% of GDP). This is, therefore, the price that the country is still paying for the problems of public and state-owned enterprises that have arisen prior to 2015. By far the greatest expenditure based on activated guarantees comes from guarantees issued for Srbijagas (about 200 million Euros), but also for Serbian Railways (35 million Euros), *Air Serbia* (10 million Euros), Galenika (10 million Euros), Železara (5 million Euros) etc. Even though the Law on Budget formally lists two different deficits of the Republic - one including and the other, excluding these expenditures - only the inclusive deficit is relevant as these are the expenditures that the government realistically has to cover.

New arrears to Srbijagas and EPS keep accumulating and we estimate that they will reach 15-20 bn dinars in 2016 - which is the greatest threat to the budget. Expenditures of public and state-owned enterprises that are covered from the budget are enormous as they are, but are threatening to become greater still, as problems with business performance, primarily in the case of non-privatized state-owned enterprises, continue. Even in 2016, numerous state-owned enterprises have failed to pay their electric and gas bills. RTB Bor alone has accumulated over 30 million Euros (4 bn dinars) of debt to EPS. In addition, Resavica, PKB, Politika, Jumko, Industrija motora Rakovica and others also failed to pay their electricity bills regularly in 2016. On the other hand, gas bills, payable to Srbijagas, were not regularly paid by MSK, Azotara, Galenika and some other state-owned enterprises. In addition to the aforementioned state-owned enterprises, local public enterprises, as well as local governments, are also on the list of those defaulting on their payments to EPS and Srbijagas. Certain city heating plants are still unable to pay their gas bills (e.g. heating plants from Jagodina and Zrenjanin), while water supply companies from Kragujevac, Bor, Smederevska Palanka and the Cities of Kragujevac and Novi Pazar owe EPS for their electricity bills. Based on these records, we estimate that new debt to Srbijagas and EPS alone in 2016 will grow to almost 20 bn dinars (160 million Euros). The Fiscal Council emphasizes that this is a problem in the making, one that threatens to bring new expenditures in the future - whether through repeated guarantees issued to Srbijagas, only to be repaid for by the government, or through further financial exhaustion of EPS, whose debts could then also fall

on the budget and increase the public debt (even though EPS's debts are mostly not covered by guarantees). In addition, there are indications that certain state-owned enterprises are also not paying for some of their other obligations, in addition to the ones mentioned (taxes, claims from the Development Fund and local public companies etc).

Fiscal Council believes that explicit subsidies to state-owned enterprises (as was done with Bor) would be the lesser of two evils, compared to allowing their debt to accumulate. A permanent solution for all non-privatized state-owned enterprises would be privatization or bankruptcy. However, hoping to privatize some of the most significant enterprises from this group, the government has decided to postpone their closure, even though all the deadlines set for the resolution of their fates have long since expired. This decision has its own considerable price - deterioration in business performance of EPS and Srbijagas, which are not being paid for the services provided to these unsuccessful state-owned enterprises. The Budget for 2017 for the first time includes funds to ensure current liquidity of RTB Bor in the amount of 2 bn dinars, which Fiscal Council conditionally supports (it would be best if RTB Bor was not making losses to begin with). Namely, if RTB Bor is unable to pay for its obligations on its own, it is justifiable that the government should cover its expenses immediately as they arise (if it still stands behind the decision that RTB Bor should continue its operations). However, RTB Bor is only one of a large number of unsuccessful state-owned enterprises that operate by not paying their bills and the expenditures of any of these other enterprises are still not included in the budget (even the subsidy planned for RTB Bor is most likely insufficient). The Fiscal Council therefore believes that, as is the case with Bor, the budget should include subsidies to cover all arrears incurred by other aforementioned state-owned enterprises. By including these enterprises into the budget, it would become completely visible and clear just how large a problem they represent. Otherwise, these expenditures will, by all foreseeable accounts, appear as a larger future expenditure for the budget (guarantees for Srbijagas, direct expenditures for Petrohemija etc). Facing the magnitude of these expenditures and the problems caused by state-owned enterprises would represent a good step towards their resolution. The Fiscal Council estimates that if these expenditures were to be included in the budget, the planned deficit for 2017 would increase to almost 2.5% of GDP.

ASSESSMENT OF THE 2017-2019 FISCAL STRATEGY

Summary

The Fiscal Strategy in principal envisages good objectives for the recovery of public finances, but does not comprise all the measures necessary for their fulfilment. The Fiscal Strategy calls for a gradual decrease of general government deficit and public debt in the upcoming three years, with similar trends forecasted in the long-term (after 2019). It has been planned that the fiscal deficit, amounting to 1.7% of GDP in 2017, should continue to decrease to 1.3% of GDP in 2018 and to 1% of GDP in 2019, while the public debt should fall below 60% of GDP in 2023 and below 45% of GDP in 2028. Therefore, lowering the public debt to a safe and sustainable zone (which, for countries like Serbia, is significantly below 60% of GDP) is foreseen to take place in about 10 years time. In order to keep this long-term process plausible, the Fiscal Strategy, as the most important medium-term fiscal plan of the Government, should comprise strict reform measures to bring the public finances to order, as well as precise deadlines for their implementation. In addition, the Fiscal Strategy would have to encompass a qualitative and quantitative analysis of the largest fiscal risks, together with measures that would be enforced if any of these risks were to materialise. The Fiscal Strategy for 2017 with projections for 2018 and 2019 brings about certain analytical improvements, recognizing the largest (but not all) fiscal risks. It also comprises a larger number of relevant data than the previous Strategies - something the Fiscal Council welcomes. However, it still does not comprise all of the aforementioned necessary elements and has a few other shortcomings, which is why we cannot see it as a good enough plan for the lasting recovery of public finances.

First, the largest decrease in fiscal deficit is planned only after the period that is covered by the Strategy in greater detail, i.e. in 2020, which is not credible. The Fiscal Strategy does not plan for the fiscal deficit to be decreased to a sustainable level of 0.5% of GDP within three years, but only in 2020. In addition, the largest annual deficit decrease has been planned for 2020, i.e. after the expiry of the period covered in detail by this Strategy. However, it should be pointed out that the planned fiscal deficit of 0.5% in the long-term is a good target. The Fiscal Strategy indirectly recognizes this deficit as a structural objective, as this level is planned to be maintained in the period from 2020 to 2027. The Fiscal Council has proposed, in its previous reports that the medium term general government deficit objective should be kept at most at 0.5% of GDP. Such a low deficit would allow for a relatively strong decrease of the excessive public debt and would have a positive effect on long-term economic growth. Furthermore, it is possible to achieve this MTO in an economically desirable manner, by implementing structural reforms and without increasing taxes or decreasing some of the productive expenditures. In the end, structural deficit target of 0.5% of GDP is also prescribed by the EU ("Fiscal Compact") for its member states that, like Serbia, have a public debt exceeding 60% of GDP. It would have been far more credible for the deficit reduction to the MTO of 0.5% of GDP to be achieved in the time span fully covered by the Fiscal Strategy (2017-2019). This would mean that the general government deficit was to be lowered in 2018 and 2019 to a greater extent than the current plan calls for, which in turn would mean a faster decrease of the unsustainable public debt. It is even more important that 2019 is the last year covered by the Strategy in terms of detailed plans of public revenues and expenditures, as well as measures behind the planned deficit decrease. Achievement of a long-term deficit of 0.5% of GDP no earlier than 2020 and planning the largest savings for that particular year, without any explanation, lacks credibility.

Secondly, the Fiscal Strategy fails to encompass the almost inevitable new budget expenditures from the unreformed public sector (primarily from state-owned enterprises). Analysis of the 2017 budget shows that the largest part of the planned deficit stems from repaying old debt of public and state-owned enterprises (Srbijagas, Galenika, Railways etc). Without the repayment of these debts, the general government deficit in 2017 would amount to about 35 bn dinars; with these expenditures, it expands to 75 bn dinars. In addition, for several years in a row, the budget has been taking over obligations from public and state-owned enterprises and state banks, above what was initially planned. Thus, in 2016, about 100 million Euros of Petrohemija's debt to NIS was taken over, which had been unplanned; earlier, the budget covered the debts of Srbijagas, JAT, PBB and others, which also was not planned for. The budget expenditures for the unreformed public sector are already enormous, but since the root of the problem has not yet been dealt with - new and extensive future expenditures are imminent. In 2016 alone, the unsuccessful state-owned enterprises undergoing privatization (together with local public enterprises and local governments) have incurred a new debt to Srbijagas and EPS that is estimated to about 20 bn dinars. Experience teaches us that these obligations will, in the end, turn into fiscal deficit and public debt, through different mechanisms. For instance, when Srbijagas was unable to collect its claims from SOEs in the past, it took out loans for liquidity and stopped paying its obligations to NIS, which was then repaid for from the budget. The Fiscal Council thus believes that deficit and public debt projections in the Fiscal Strategy had to take into consideration these expenditures as well. The cleanest solution would be to include all expenditures of state-owned enterprises into public expenditures, i.e. to subsidize them from the budget as they arise and not to let them accumulate in the form of uncollected claims of EPS and Srbijagas. This would increase the annual fiscal deficit by about 0.5% of GDP, but this expenditure if postponed will only become larger. In addition, transparent inclusion of these costs stemming from poor performance of state-owned enterprises into the public expenditures would, we believe, lead to resolving of their status in a more timely manner.

Thirdly, there is no exit strategy for temporary fiscal consolidation measures. Legislated decrease of pensions and salaries in the public sector has been defined as temporary, although these measures represent one of the key pillars of fiscal consolidation. Namely, the temporary pension and salary cut decreases the annual deficit by about 1.7% of GDP and without these measures, the fiscal consolidation would have no chance of success. Therefore, an abrupt termination of such a measure would annul the fiscal consolidation results achieved thus far, as it would roll back the deficit to the level of 3.5-4% of GDP, relaunching an accelerated public debt growth. The Fiscal Strategy, however, provides no concrete plan for the completion of these temporary measures. The Fiscal Council believes that the Government should have taken a proactive position in this matter and defined a fiscally responsible model for going from temporary to permanent way of determining pensions and salaries level in the public sector. For example, general government salaries could be defined, without excessive fiscal cost, within the announced regulation of pay grades, and specifically, the salaries at the local government level should also be considered within the systemic harmonization of obligations and revenues of local governments (which includes transfers from the state budget). A special challenge lies in regulating salaries in public enterprises, as some of them (EPS) have made up for the salary cut of 10% by an equal raise in bonuses. Cancellation of the temporary salary cut in public enterprises would increase the fiscal deficit by 0.4% of GDP, but in addition, in some of these enterprises it would also lead to an unjustified increase in salaries.

Fourthly, a plausible plan for the implementation of structural reform is necessary; one that would ensure and improve on the consolidation results achieved so far. The successful fiscal deficit reduction of about 2% of GDP achieved thus far rests, in a

large part, on a strong increase in collection of public revenues and certain non-systemic savings in public expenditures. The Fiscal Council believes that this deficit decrease will not be maintained if these savings are not supported by structural reforms.

In the first place, we would like to emphasize the need to *modernize Tax Administration*. The increase in collection of public revenues in the previous two years was founded, to a large extent, on suppression of grey economy and *ad hoc* measures of the Tax Administration in the field, without reinforcement of its resources and with an unchanged organisational structure. However, it should be noted that the average age of Tax Administration staff is over 50, there is an insufficient number of inspectors in the field, analytical capacities are weak, organisational structure and information system obsolete etc. We hence believe that it is not very likely that public revenue collection will be maintained at the current level unless the Tax Administration is modernized, which has not been recognized in an adequate way in the Fiscal Strategy. Namely, the Fiscal Strategy would have to provide an answer to an obvious delay in implementing the Tax Administration Transformation Program for the period 2015-2020 (instead of just referring to the document) and to prescribe clear measures and new deadlines in which these measures would be implemented, etc. A successful modernization Tax Administration is almost crucial for the recovery of public finances. It would not only ensure that the achieved results in the revenue collection are maintained, but could also lead to further revenue increase in the upcoming years, as there is still room for the suppression of grey economy (assessment from the Fiscal Strategy on a possible increase in VAT income by 1.8% of GDP from the suppression of grey economy, however, is not very likely).

Even though the *rationalization* in general government has not met its initial objectives, certain savings came from the natural outflow of employees who retired, with the employment ban still in force. These savings, however, are neither systemic nor sustainable in their nature. Namely, both the productive and the non-productive employees retire and the prolonged employment ban through 2017 would already become a threat for the functioning of certain important segments of general government (education, healthcare etc). In addition, the analysis of the Fiscal Council shows that in similar episodes of linear downsizing were always short lived. For instance, the IMF Arrangement from 2002-2006 also lead to a linear downsizing. However, soon after the Arrangement ended, statistics show that the number of employees in the public sector bounced back to the previous level, or even exceeded it (Figure 1). In order to prevent similar situations from repeating in the following years, it is necessary to initiate a reform of the largest public systems, primarily healthcare and education. One of the outcomes of these reforms should be a clearly defined number and structure of the employees needed in these sectors, which would prevent an excessive and unjustified increase of employment once the employment ban has been lifted.

Fifth, there are announcements of tax relaxations and increases in expenditures that Serbian public finances cannot absorb. If all of the aforementioned problems remain unresolved, it will be very unlikely that the (generally good) objectives of the Fiscal Strategy shall be achieved. Furthermore, lately there have been frequent announcements from the Government on lowering the fiscal burden of labour and/or additional increases in certain public expenditures (larger and more frequent indexation of salaries and pensions, new programs for agriculture that could have fiscal implications etc). The Fiscal Council believes that Serbian public finances or, more precisely, the excessive public debt that will remain far above the sustainable level in the medium term, do not leave sufficient room for the implementation of these policies. Therefore, if the Government was to decide on one, or several of the aforementioned measures, it would have to compensate them with proportional new savings or through an increase in public revenues (e.g. VAT increase). If not, the

implementation of measures leading to a significant increase in public expenditures or a decrease in public revenues could jeopardize the painstakingly achieved fiscal stability.

The Fiscal Council deems the plan for public debt decrease not entirely plausible. Excessive public debt is currently the largest issue with Serbian public finances. It is good that the growth of public debt in terms of GDP was finally stopped in 2016, but now there is a need for its long-term lowering to a level that is far below the Maastricht criteria of 60% of GDP. Namely, the danger zone for debt crisis outbreak is set at a far lower level for developing countries than for developed countries. This is why Central and Eastern European countries (comparable to Serbia) usually have a more restrictive maximum level of public debt in their national legislation than is required by the Maastricht rules (usually at about 50% of GDP). With such a public debt decrease, Serbia would be prepared for an eventual adverse shock, which is bound to happen in the long term. For this reason, a significant decrease of public debt would have to be the most important fiscal policy objective in the years to come. The Fiscal Strategy envisages a relatively strong decrease of the level of indebtedness; however, it fails to present a credible plan that would guarantee the achievement of this objective. Moreover, reaching a safer level of public debt will be rendered additionally difficult by the inclusion of restitution obligations. The Fiscal Council therefore cautions that it is too early to call the fiscal consolidation completed, especially since the burning issues of public finances, primarily pertaining to public and state-owned enterprises, have not been resolved yet. If a responsible fiscal policy is not maintained in the upcoming years and if the most significant structural reforms are not implemented, Serbian public finances will be left permanently in the unsafe zone, in which all it takes is a single new external shock (and an ensuing recession) to bring back the immediate danger of a public debt crisis.

Figure 1: Number of employees in healthcare and education in Serbia, 2002-2009