ASSESSMENT OF FISCAL TRENDS IN 2012 AND CHALLENGES FOR 2013 AND 2014

Basic assessments

After the 2012 deficit met expectations, fiscal flows deteriorated in the first two months of 2013. Preliminary data for January and February 2013 confirm the Fiscal Council's assessments from November 2012 – 2013 deficit will exceed the planned 3.6% of GDP. For the time being, it is still difficult to make a reliable assessment on how high this overrun may be. We do not exclude the likelihood of 2013 deficit amounting to around 4.5 % of GDP, as we similarly assessed in the end of 2012. Even this deficit level requires certain fiscal flow improvement in the upcoming months. We are particularly concerned about numerous state initiatives and interventions which were announced ("Železara Smederevo" (Smederevo Steel Mill) and some other companies, settling the liabilities of the dissolved Environment Protection Fund, budget support to some economic branches, etc.). Most of these expenditures will be posted under a posting method by which fiscal deficit is not increased formally. However, each of these interventions implies state expenditure and public debt increase. Hence, it is irrelevant whether these expenditures are included in the budget or not.

So as to avoid the public debt crisis, the deficit should be reduced drastically in 2014. However, there is still no plan for this. Comprehensive measures from October 2012 (real reduction of pensions and public sector wages and tax increase) enabled an important reversal in the fiscal policy. Thereby, public debt crisis was postponed but still not avoided. In order to fully remove the risk of the public debt crisis, it is necessary to continue reducing the fiscal deficit in the period 2014-2016. 2014 is particularly important since this is when fiscal deficit should be reduced by 1.5-2 percentage points (pp) of GDP in comparison to the one from 2013. We made calculations which proved that there are currently around €400-450 million of extra adjustments missing which equals to real reduction of wages and pensions of around 5% or VAT increase by additional 2 pp. In both economic and social terms, it is much better to launch the reforms in 2013 and amend certain laws such as the one on local self-government financing instead of taking some of the given measures again. The first option would also bring necessary deficit reduction but we think it would be also less painful and more rational in economic terms.

The 2012 deficit of RSD 217 billion (6.6% of GDP) was in line with the 2012 budget rebalance although both public revenues and public expenditures were considerably lower than the planned ones. Public revenues were around RSD 25 billion lower than the planned ones, which represents an extremely big deviation, bearing in mind that the budget rebalance was developed in September with only three months till the end of the year. The largest discrepancy was recorded with excise based revenues (tobacco), non-tax revenues and VAT. Public expenditures were around RSD 30 billion lower than the planned ones, primarily as a consequence of lower execution in the field of planned expenditure for the procurement of goods and services.

2012 trends indicate indirectly that the 2013 deficit will surpass the planned one. So as to see the implications of the trends from the end of 2012 to the 2013 deficit, we decided first to make the assessment on which factors from this period were temporary (one-off) and which will have affect 2013 as well. For example, the temporary factor which contributed to public revenue reduction in 2012 was one-off hoarding of tobacco products as a reaction of tobacco companies to excise policy amendments. In our opinion, another one-off factor is lower expenditure for the procurement of goods and services and therefore, we expect that, in 2013, at very best, the plan will be materialized but savings similar to those in 2012 will not be made. On the other hand, 2013 deficit will be affected by an overrated basis for the excise- and VAT-based revenues projections, which will result in their shortfall. The analyses of a great number of different indicators from the end of 2012 point out that, in total, 2013 deficit will exceed the planned one – which, in principle, corresponds to our evaluations from November 2012.

In the first two months of 2013 there was a disturbingly high deficit in the republic budget of around RSD 35 billion. If similar trends continue by the end of the year, such a high deficit from the first two months would equal to annual republic deficit of over RSD 200 billion – instead of the planned republic budget deficit of RSD 122 billion. The main reason for a high deficit in January and February is public revenue reduction, VAT based revenue in particular, while public expenditures were under control, in principle.

We expect certain improvements in the upcoming months but these will still not be sufficient to make a reversal in the current trends. In the end of 2012, there were significant changes in the VAT collection system (payment upon collection, raising the limit for quarterly settlement of tax liabilities, raising the threshold for the inclusion in the VAT system, etc.). This is why a share of public revenues which fell short in the beginning of the year will be compensated in the following months which will cause the deficit reduction in the middle of the year. Therefore, it is not justified to conclude that 2013 deficit will be almost twice as big as the planned one - which is indicated at first glance by the results in the first two months. However, taking into account possible improvements in the future, our preliminary analyses of the dynamics in the first two months of 2013 indicate that the whole accumulated deficit is not a consequence of temporary factors alone and that it will not be possible to fully compensate for it in the upcoming months.

New Government interventions further deteriorate the fiscal flows. As early as in the end of 2012, we warned that no funds were planned for "Železara Smederevo" in the 2013 budget, although sizeable budget funds were allocated for this company as early as in 2012. Since optimistic expectations of prompt company privatization did not materialize, there are now additional (unplanned) state expenditures in 2013 for this. Although a creative solution was found for this state intervention (as well as for some others) by which the deficit is not increased formally – this operation as well as the similar ones should be basically considered as a part of budget expenditure.

Therefore, real 2013 deficit could easily exceed 4.5% of GDP. As we have already mentioned, due to system changes, fiscal flows indicators in the first two months of 2013 still cannot make a sufficiently reliable basis for 2013 deficit evaluation. Therefore, for the time being, we hold to the expectations similar to those expressed in November 2012 – 2013 deficit could amount to around 4.5 % of GDP (if there is sizeable improvement of public revenue in the coming months). However, if now we add to it new state expenditures, which in line with the first announcements will not be posted as a deficit (Železara, the debts of the Environment Protection Fund, etc.), we could estimate that the 2013 deficit will reach even 5% of GDP.

We also think that it is necessary to adopt and follow quarterly budget execution targets so as to take corrective measures in due time. The Fiscal Council's initiative from 2012 was to define and follow quarterly budget execution targets for 2013. In addition, the Fiscal Council is willing to participate in the process of definition of these targets as well as in the analysis of the results achieved. We wanted to try to avoid unduly response to aggravated fiscal flows and thereby prevent the 2013 deficit of getting out of control. After preliminary consent from the Ministry of Finance and Economy, we expect that until the end of first quarter, we may make a final agreement on quarterly targets.

In the end of 2012, public debt amounted to 63% of GDP. During one year only, public debt was increased by over € 3 million and its share in GDP was increased by over 13 pp of GDP. Public debt growth trend in unsustainable and it will inevitably cause crisis which is why it is necessary to make a reversal. The Government is also legally bound (Budget System Law) to launch the program of public debt reduction once the public debt exceeds the level of 45% of GDP.

The measures from October 2012 postponed public debt crisis breakout, but permanent removal of this threat takes a sizeable deficit reduction in 2014 as well. In order to reverse the public debt growth trend permanently and prevent the crisis, it is necessary to reduce the deficit in 2014 further in comparison to 2013 by 1.5-2 pp of GDP which was accepted as the Government target in the Fiscal Strategy. We made calculations which indicated that the level of the missing adjustment in 2014 - so as to achieve the given targets – amounts to between € 400 and 450 million. It will be no easy task to make an adjustment of such scale. Therefore, as it is also stipulated by the Budget System Law, the Government should present the first budget framework for 2014 as early as in April and this framework should include a credible plan for deficit reduction.

In this Report, we would like to remind once again of the reforms which must be launched in the first half of 2013. In its Fiscal Strategy for 2013, the Government envisaged launching the reform of public sector wages and employment, working on the completion of the process of state-owned companies restructuring, reforming public enterprises, developing social cards, initiating the pension reform, etc. In section 5, ("Reforms Planned for 2013") we made a short review of the given reforms and the evaluation of their implementation. It is worth noting that, as we proposed several times, we would include the establishment of a sustainable model of fiscal decentralization in the list since we think that it is almost impossible to implement the necessary fiscal consolidation without it.

There is progress made in solving the problem of accumulated arrears of the state bodies, but we consider that the republic budget should assume the liabilities more cautiously. In the second half of 2012, state bodies arrears were reduced but they are still very high and they amount to around RSD 54 billion (1.6% of GDP). Therefore, in 2013, it is very important to deal with the problem of existing arrears as well as prevent the creation of new ones. The Government adopted The Law on Payment Deadlines in Commercial Transactions stipulating a 45-day deadline for the public sector to settle its future liabilities. A separate law stipulated that unsettled liabilities of health care institutions (amounting to up to RSD 13 billion) are included in the public debt, with repayment in twelve quarterly installments as of the end of the first quarter of 2013. The Government also offered the local self-government and their creditors to assume the debt repayment for realized capital investments (by the emission of bonds to the creditor's benefit). The local self-government would be repaying the debts to the state later (the Fiscal Council has certain doubts about this proposal). The Fiscal Council supports an active Government approach regarding arrears settlement. However, we would like reiterate our position - the biggest part of the burden of repayment of accumulated arrears should be borne by those state bodies which created those arrears. Otherwise, it may be easily understood that, in the end, the central government will always assume the liabilities created by some state bodies, which would stimulate their irresponsible finance management in the future.