Republic of Serbia
**FISCAL COUNCIL**

# OPINION ON FISCAL STRATEGY DRAFT FOR 2015 WITH PROJECTIONS FOR 2016 AND 2017

## Summary

**The programme presented in the Fiscal Strategy could bring about a recovery of public finances, however, only if additional conditions are also met.** The Fiscal Strategy presents a fiscal consolidation plan which could reverse the ascending trajectory of the public debt, thus avoiding the crisis. This plan is good *en général*, however, it can achieve its objectives on certain conditions only. *First*, the fiscal consolidation must be extended to 2018 as well, i.e. a four-year programme should replace the three-year one. To be specific, given the current Government plan, the ascending public debt trajectory cannot be reversed by the end of 2017 (though the Fiscal Strategy claims otherwise), therefore additional measures are necessary in order to have the deficit reduced by approximately €300 million in 2018 as well. *Second*, the plan should also include contingency measures to become effective automatically in case of a deadlock in the implementation of certain (risky) parts of the programme. As an example, resolving the fate of the Petrochemical Complex by mid 2015 or optimizing the number of public administration employees are good, but uncertain measures – because of which it is necessary that the Government has alternatives measures ready if anything of those is not implemented. *Third*, is it is necessary to conclude arrangement with the IMF which would monitor such a programme. This would ensure credibility of the fiscal consolidation programme with the foreign creditors, despite the fact that the public debt share in the GDP could not start decreasing prior to 2018 when it would exceed 83%. Additionally, we find that the presence of the IMF would improve prospects for a successful implementation of the risky, severe and definitely unpopular measures. *Finally*, a larger increase in the public investments is necessary so as to give a much needed boost to the economy and prevent the ongoing recession jeopardize fiscal consolidation efforts.

**Fiscal Strategy outlines a desirable reversal in economic policy; nevertheless, it also shows some systemic deficiencies, being insufficiently developed measures and over-optimistic expectations.** The Fiscal Strategy presents an undisputable intention of the Government to start addressing accumulated problems in public finances. As a matter of fact, those problems are already deep that any other alternative but facing the necessary reduction, to be followed by freezing the salaries and pensions, letting redundant employees go and changing the manner in which the public companies operate – are no longer the alternatives. Because of the poor condition of public finances, and the overall economy, the fiscal and macroeconomic prospects should be considered in the medium-term period as impartially as possible. The Fiscal Council assesses that it is not probable to have the majority of

(optimistic) forecasts as presented in the Fiscal Strategy realized, especially the ones referring to the medium-term growth of economic activity, RSD exchange rate trends and the public debt trajectory. The Fiscal Strategy should also consider and plan better all aspects of suggested measures for the deficit reduction. We deem that this is not the issue of improving the planned fiscal adjustment quality only, but also a necessary condition to have that adjustment happen at all. As an example, there are undoubtedly redundant employees in the public sector, however, instead of first determining precisely the optimum number and professional qualifications of employees in all individual areas of public sector, only then to be followed by a well thought-out and aimed rationalization – *ad hoc* solutions, which could easily prove to be unsustainable, have been imposed

**Fiscal Council's analysis indicates that the ascending trajectory of the public debt will not reverse prior to 2018, when the public debt will reach approximately 83% of the GDP.** Although the Fiscal Strategy envisaged that the public debt of the Republic of Serbia will reach its highest level of 79% of the GDP in 2016, to subsequently gradually decline as of 2017, the analyses of the Fiscal Council indicate that this will not happen. Already by end 2014 the public debt has reached 72.2% of the GDP (the Fiscal Strategy drafted by mid December has optimistically estimated it to 69.9% of the GDP), thus even the starting points in the projections of the Ministry of Finance and Fiscal Council differ. Additionally, the slower growth of the public debt relative to GDP, which is forecasted in the Fiscal Strategy as compared to the Fiscal Council's projections, is, in our opinion, also a consequence of ungrounded assumption that Dinar will in the next three years realistically grow stronger against Euro. The Ministry of Finance has planned an average exchange rate of 120 RSD against one Euro in 2015, and 121.5 RSD and 123 RSD for one Euro respectively in 2016 and 2017. The Dinar exchange rate fluctuation is unpredictable, therefore it is not impossible that these forecasts eventually come true; nevertheless, the Fiscal Council finds it would be more unbiased if the projections assumed the Dinar exchange rate against Euro would in the years ahead remain realistically unchanged, the more so given that the forecasted average Dinar exchange rate for 2017 has already been exceeded by mid January 2015. Finally, the Fiscal Council deems the forecasted real GDP growth rate of 1.5% in 2016 to be most likely unattainable and that instead, the economy growth rate in 2016 might be 0% (see Chapter: "Assessment of Macroeconomic Projections from the Fiscal Strategy"). Due to all the above-mentioned, we think that the public debt share will exceed the Fiscal Strategy projections by more than 4 p.p. of the GDP and that its growing trend will not reverse by 2017.

**In order to have the public debt growth halt, a four-year (instead of a three-year) fiscal consolidation plan is necessary.** The analysis presented in the previous paragraph may also be substantially considered from the other aspect. In order to stop the public debt growth relative to GDP, fiscal deficit should have to be lowered to bellow 3% of the GDP, while the Fiscal Strategy envisages the 2017 deficit of 3.8% of the GDP. This indicates that in order to have Serbia's public finances recover it is necessary to carry on with severe reduction of the fiscal deficit by approximately 1 p.p. of the GDP in 2018 – i.e., to extend fiscal consolidation to that year as well. Maybe the best illustration of how big this adjustment in 2018 would be, is the fact that a deficit reduction of 0.9% of the GDP in 2017 has been envisaged on the grounds of the salary and pension freeze (along with 4% inflation) and 5% discharge of employees in the budget sector be in effect that year.

**There is a big risk for the medium-term public debt growth to be even higher than the projections of the Fiscal Council.** The problem we especially stress is that the government has within the past three years borrowed mostly in United State Dollars, although by far the largest portion of the foreign currency revenues of domestic economy is generated in Euro. Simplified, the government is now in a situation rather similar to the one the Swiss Francs borrowers are in. Because of a much more favourable notional interest rate for US Dollar borrowing in the previous years, the government mostly opted for the borrowing in this currency (the Eurobonds issued are actually in Dollars, as are credits of the UAE, Russia, World Bank, etc). These credits which at first appeared to be very favourable, have now become the most costly portion of the public debt due to a severe Dollar appreciation against both Dinar and Euro. If the US Dollar appreciation trend continues in the next years (and there are relevant predictions that it might), Serbia's public debt and interest outflows will continue to grow also in the future, regardless of new borrowings. That is why it is important to act on the announcements in the Fiscal Strategy that the Government will consider the possibility of issuing Eurobonds denominated in Euro, as well as for the use of the mechanisms by which the government might protect itself against the foreign currency risk (the practice being already successfully applied in some neighbouring countries).

**The Fiscal Strategy has planned measures which would permanently decrease annual government expenditures by approximately €1.7 billion.** Fiscal consolidation measures should reduce the government deficit from approximately 6.6% of the GDP (as estimated for 2014) to 3.8% of the GDP in 2017. This, however, assumes the medium-term savings much greater than 3 p.p. of the GDP (€1 billion) as seemingly indicated by the reduction.

Due to the inevitable public debt growth, the government allocations for the interests will by 2017 increase by more than 1 p.p. of the GDP (from 3% of the GDP in 2014 to over 4% of the GDP in 2017). Public investment expenditures will also have to increase by 0.5-1 p.p. of the GDP since at the moment they are unsustainably low, while due to rebalancing of economy (decrease in spending with the growth of investments and net exports), the share of the VAT revenues in the GDP will decrease by approximately 0.5 p.p. That is why the Government has planned to ensure by fiscal the savings of more than 5 p.p. of the GDP or €1.7 billion approximately, in order to achieve the envisaged fiscal deficit reduction.

**The principal savings have been planned in expenditures for the budget sector employees.** It is anticipated that the government wage allocations be decreased on three grounds: 1) nominal wage decrease of 10% (November 2014), 2) wage freeze by 2017 which, with the current inflation projections, implies their realistic decrease by 10% approximately and 3) a reduction of the number of employees by 5% annually (a total of 15% or some 75,000 employees). These measures will reduce government allocations for wages by as much as 30% in 2017 as compared to 2014. The government plans to achieve somewhat smaller savings on pensions, which, according to the plan, will not be indexed against inflation till 2017, after already implemented decrease in November 2014 (by which the government pension allocations have been lowered by 5%). Given the projected inflation trends, government pension allocations will in the realistic amount decrease by 2017 by approximately 12% as compared to 2014. Out of other planned savings, the most important ones are the ones to be achieved by restricting the right to agricultural subsidies per hectare (not more than 20 hectares), by abolishing public services subsidies as of 2016, along with gradual reduction of Railroads subsidies.

**The second pillar of the fiscal consolidation is putting public and state-owned companies in order.** The Fiscal Strategy has planned that as of 2015 the government will no longer cover for the losses of public and state-owned companies by issuing new guarantees for their borrowings. This requires a complete and immediate reversal of the operation of the "Srbijagas" (*Serbia Gas*) and "EPS" (*Electricity Supply Company*), as well as the privatization/resolution of the fate of the "Železara Smederevo" (*Smederevo Steel Works*), "Petrohemija" (*Petrol-Chemistry*), "Azotara" (*Nitrogen Plant*), "MSK" (*Methanol-Vinegar Complex*) and others. "Srbijagas" is the biggest loss-making company in Serbia and at the moment is entirely dependent on government's assistance. The main reason (albeit not the only one) for the "Srbijagas" losses is that it keeps supplying other state-owned companies ("Petrohemija", "Azotara", "MSK", "Železara Smederevo") that never pay their dues. That is why the Government's decision to suspend further assistance to the "Srbijagas" actually means that the fate of the above-mentioned companies will be resolved in the first half of 2015. Although the "EPS" so far has not been receiving direct budget support for covering the losses this is bound to happen very soon if it's business operations are not changed. Since the Government does not plan rendering any such assistance to the "EPS", it has implicitly assumed the obligation to start addressing accumulated problems of this company in 2015 and to even permanently resolve some of them – redundant employees, low prices and electricity collectability, technical losses and theft, etc.

**Some of the key measures of fiscal consolidation are very risky – first of all, reducing the number of employees without a pre-developed plan and solving the public companies problems in a short time.** It is planned that by 2017 the number of budget sector employees be reduced by a total of 15% (5% annually), which is about 75,000 employees. The Fiscal Strategy emphasizes: "we reckon that the biggest part of this reduction would be achieved through a natural outflow of employees, i.e. by retirement with a limited filling in of the vacant posts". The analysis of the Fiscal Council indicates that not only this cannot be achieved in this manner (by avoiding discharging the majority of redundant employees), but that it would not be appropriate, even if it were possible. There is no alternative to profound analyses and precise plans stating in which parts of the public sector and to what extent the number of employees should be reduced, as well as to state clear criteria and methods by which the most unproductive employees would be let go. Additionally, it is necessary to also prepare the reforms of the health and education systems (approximately one half of a total number of government employees), so as to enable these extremely important parts of the public sector to maintain (if not to improve) the quality of their services even despite a significantly smaller number of employees. The deadlines set by the Government for resolving the problems of public and state-owned companies are short, but the mode in which it will happen has still not emerged. The Petrochemical Complex could "survive" through privatization and investments for which the government lacks resources (probably the knowledge, as well), whilst the current volatile situation in global energy sector does not indicate the possibility of the arrival of any serious foreign investors. Also, the details on the reform of the biggest state-owned company, the "EPS", are still unknown. This company undoubtedly has serious organizational problems, the solving of which is, according to the publicly accessible data, underway as we speak; nevertheless, it would be much more credible if, for example, the "EPS" also developed a detailed discharge plan for redundant employees or reached agreement with the government to increase electricity price.

**Another shortcoming of the Fiscal Strategy is that it lacks any contingency measures whatsoever.** The Fiscal Strategy does not indicate what the Government's alternative plan might be if all the savings planned are not realized, which is highly likely given some of the planned measures are rather risky. Giving up the fiscal consolidation goals will undoubtedly usher Serbia in the public debt crisis; thus, the only alternative is that new measures be immediately adopted to offset the potential savings shortfall relative to the plan. A responsible short-term fiscal policy planning would also imply the analysis of such scenarios in the Fiscal Strategy and suggesting contingency measures which would become automatically effective in case of a deadlock in the implementation of any of the originally planned measures. Such approach would be useful for several reasons: 1) it would additionally guarantee the implementation of the most important goals of fiscal consolidation, even in case that any of the proposed measures fail, 2) it would contribute to higher credibility and seriousness of the Government's programme which could have a positive effect on the foreign creditors trust, 3) the Fiscal Council and other institutions involved would have the opportunity to also present in due time their respective opinions and recommendations for those additional measures which could improve them and 4) the *ad-hoc* resolution of possible problems at the moment when they emerge, which is always dangerous, would be avoided.

**The Fiscal Strategy projection of public revenues trends is generally good.** The Fiscal Strategy has planned a decrease in the public revenues relative to GDP by approximately 2.5 p.p. in 2017 as compared to 2014. This is a consequence of expected economy rebalancing – slower growth of the tax generous spending in comparison to the net export and investments which are mostly tax-free. Besides, certain fiscal consolidation measures, like wage decrease and reduction of the number of public sector employees, will result in a decrease in the contribution revenues, a development also well predicted by the Fiscal Strategy. A risk noticed by the Fiscal Council is that the projections of non-tax revenues rely on uncertain increase of dividends from the public companies. On the positive side, we emphasize that possible revenues for curbing shadow economy have not been included in the public revenues projection, which is in line with the good budget practice and earlier suggestions of the Fiscal Council. As a rule, these revenues have earlier been included in the budget plans, which, for example, was one of the main reasons for the generated public revenues to fall short of the budget plan in 2014. Undoubtedly, there is room for curbing shadow economy and increase in public revenues based on this; however, in order to implement this, systemic measures for upgrading inspection services operation as well as the Tax Administration reform are necessary.

**Public expenditures have been well projected; whether the planned projections will be realized, however, depends primarily on a successful implementation of the most important fiscal consolidation measures.** The planned fiscal consolidation is based on reducing the expenditures and the Fiscal Strategy projections of the public expenditure trends by 2017 are consistent with the measures planned. Thus the projection of the trends of government wage allocations takes into consideration the assumption that the wage freeze will be applied to nominal wages up to 2017 and that the number of employees will each year be reduced by 5%. If, however, the Government fails to implement a good enough wage control and they grow despite legal restrictions (which regularly happened in the past), or if the number of employees is not reduced as planned, the projections of these expenditures trends by the Ministry of Finance will not be realized.

**Public investments allocations must be increased so as to prevent the ongoing recession from threatening fiscal consolidation.** The increase in public investments is one of the rare measures by which the government can significantly boost the economy activities, which is now especially important given that Serbia is in a perilous recession. There are also numerous other reasons because of which a powerful increase in public investments is necessary – the quality of infrastructure in Serbia has by all relevant researches been assessed as poor, there are unquestionable priorities like the Corridor 10 construction and financial funds for the majority of big investment projects have already been ensured on favourable conditions. The Fiscal Strategy has planned for only 3% of the GDP be allocated for the public investments in the next three years, although they should actually amount to 4-5% of the GDP. The Fiscal Council has hereby assessed that the increase in public investments, even at the cost of a slight deficit increase, would not threaten fiscal consolidation; it could even support it by giving the much needed incentive to economic growth. The additional problem, which should be considered, is the fact that the government is extremely inefficient in executing planned investments. Due to this, realized investments in the previous years were much lower as compared to even those, deficient plans (the execution of public investments in 2014 amounted to 2.5% of the GDP only, although the plan was that they amount to approximately 3.5% of the GDP). Because of an immense significance of this topic, the Fiscal Council is preparing in a separate document a more detailed analysis of public investments and the hindrances due to which they are not executed efficiently.