Republic of Serbia
Fiscal Council

ASSESSMENT OF THE 2013 DRAFT BUDGET LAW AND DRAFT FISCAL STRATEGY

November 13, 2012

Next year – crucial

- At the close of 2012, public debt is likely to exceed 60% of GDP, while the deficit will exceed 6.7% of GDP – unsustainable, crisis poses threat
- So as to avoid the crisis, it is crucial to make the following steps in 2013:

1. Strong deficit reduction
   – 2013 Draft Budget Law
2. Launching comprehensive structural reforms
   – Which will bring further deficit reduction and reverse the trend of public debt growth as of 2014
   – Draft Fiscal Strategy should present a credible plan of structural reforms

Basic assessments of the 2013 Budget Law

- According to the plan, state deficit is to go down in 2013 from 6.7% of GDP to 3.6% of GDP
  - Fiscal Council thinks it is a good reversal (if successful)
- Tax increase and limitation of growth of wages and pensions are the grounds for deficit reduction
  - In line with our recommendations, but there are still other strong measures missing (local self-government?)
- Fiscal Council assessment: deficit will be reduced significantly, but it will probably exceed 3.6% of GDP
  - Deficit will be RSD 25 billion higher than planned (4.3% of GDP) – primarily due to larger expenditures
  - Solving the problem with accumulated delays – (deficit may even reach 5% of GDP)

Basic assessments of the Fiscal Strategy

- A sharp path for deficit reduction was accepted (3.6% of GDP in 2013, 1.9% of GDP in 2014 and 1% of GDP in 2015)
- The effects of limitation of growth of pensions and wages and tax increase will reflect only in 2013…
- … Therefore, as of 2014, accomplishing planned deficits will depend on the implementation of structural reforms
  - True fiscal consolidation and it is based on public expenditure reduction
- Reforms should be launched in 2013
  - First results will be visible in 2014 at the earliest
- Our assessment: Draft Fiscal Strategy recognises significant reforms…
  - …But it still does not offer a plan good enough

Crucial measures in 2013 – budget

- Tax increase and limitation of growth of pensions and wages are core adjustments in 2013
- Measures are economically justified:
  - The greatest increase is seen with consumption taxes (VAT and excises)…
  - … and profit tax, which used to be very low in Serbia
  - Public sector wages and pensions expenditure were way too high for the economic strength of Serbia (the highest share in GDP in Europe)
- Tax increase and limitation of growth of pensions and wages alone cannot reduce the deficit to 3.6% of GDP
  - It is necessary to reduce public expenditure further…
  - … which must be planned in a credible manner in the 2013 budget

Budget Law – revenue assessment

- Initially, there were optimistic public revenues plans (for RSD 10-15 billion)
  - In particular, the growth of profit tax and non-tax revenues
- The plan will be probably fulfilled due to higher inflation
  - The budget was drafted with average inflation in 2013 – 10.1%
  - We expect higher average inflation – around 11.6%

  => Public revenues will be nominally higher in that case (and in line with the budget)
- The inflation rose faster in September and (expectedly) in October 2012
- In late 2012 inflation reached around 13% (instead of 11% as expected)
  - It has already increased public revenue in late 2012 (lower deficit possible)
  - Higher inflation in late 2012 is the main reason for average inflation increase in 2013 (shifted growth)

Budget Law – expenditure assessment

- Public expenditure plans were very restrictive (real drop of over 6%) – economically justified
  - Investment growth should be predicted (slight reduction of share in GDP in 2013 from 3.9 to 3.8% of GDP)
- But, public expenditure will probably exceed the planned level by around RSD 25 billion
  - Optimistic expenditure plans, around RSD 20 billion (goods and services, subsidies, interest rates)
  - Faster inflation, up to RSD 5 billion (social welfare expenditure, partly goods and services)
- Successful implementation of 2013 budget will depend on the public expenditure side primarily

Budget Law – goods and services

- Plans imply a realistic drop of expenditure in terms of procurement of goods and services (with other current expenditures) of even 17% as compared to 2012
- But without concrete measures – only budget limitations
  - It did not prove to be successful in the past
  - Higher inflation further hinders the fulfillment of the plan
- Some savings in the area of goods and services in 2013 are possible to be made
  - No one-time expenditure as in 2012 (elections)
  - Abolition of own-source revenues
  - Improved control of realisation and planning (early notification system)
- We still estimate that goods and services expenditure will exceed the level of up to RSD 10 billion as given in the plan

Budget Law – subsidies

- Basically, subsidies were not significantly reduced
  - Reduction only in terms of the fact that the Fiat project is close to completion (it has not been fully completed yet, but state liabilities are much lower)
  - Some programs are significantly expanded (construction of apartments, credits for the Republic of Srpska, for solvency, FDI), while some completely new programs are being introduced (shipbuilding)
- Subsidies threaten to go beyond control
  - Insufficient funds planned for subsidised credits for solvency which have already been approved (at least RSD 2.5 billion missing)
  - Subsidies for FDI – RSD 8.1 billion planned, RSD 7.8 billion already arranged
  - Agricultural subsidies – new law without fiscal impact assessment, big risks
- We estimate that 2013 subsidies funds will exceed the level of up to RSD 10 billion as it was planned

Budget Law – interest rates

- Interest rate expenditures are rising in 2013 significantly – by around RSD 25 billion
  - Planned interest rate expenditure in the republic budget exceeded individual expenditure for goods and services, subsidies, capital expenditure
  - It also exceeds state expenditure for police, army, agriculture…
- Growth of interest rate expenditure is a direct consequence of public debt growth
  - Additional reason why the public debt share in GDP must be significantly decreased
- We expect that interest rate expenditure will be RSD 5 billion higher than the expenditure planned in the budget
  - It may be even higher if RSD faces real depreciation

Serious risks of higher deficit

- Deficit may be increased further (over the estimated RSD 25 billion)
  - Funds were not allocated for Železara Smederevo – privatisation may not be fast and successful
  - Public announcements have already been made on extending the program “thirteenth pension”, while the planned budget includes only the two remaining installments of this one-time social measure
- Still, the highest and the most dangerous risk is to abandon planned pensions and wage indexation
  - Since this is the most important measure of public expenditure control (and deficit reduction, with tax increase)

Overdue is moving to the forefront

- Overdue payments by the state have reached great proportions
  - There are no fully reliable data, but they reached between 1 and 1.5% of GDP (€400 million)
  - Main “culprits” are Republic Fund of Health Insurance (RFZO) and local self-government
- The state should intervene but under certain preconditions
  - To reform unsustainable systems and establish the rules so as to avoid new overdue
  - To limit the intervention of the Republic in 2013 to 0.5 of GDP at most
  - Part of the burden to be carried by those who caused the delay, negotiations on discounting, rescheduling, etc.
- Solving the problem with delays will increase the public debt and deficit in 2013 by around 0.5% of GDP
  - One-time deficit increase in 2013 is likely to be an imperative (new goal – deficit from 3.6 to 4.1% of GDP)

Prevent overgrown budget deficit

- 2013 deficit may exceed the plan by around RSD 25 billion due to unrealistic public expenditure planning
- By additional RSD 15-20 billion due to accumulated overdues payment
- There is also an additional risk with expenditure as mentioned previously

⇒Therefore, deficit can easily exceed 5% of GDP

- It is necessary to define the measures which will prevent deficit growth
  - There is room for additional savings –shifts to local self-government (around RSD 10 billion), unjustified extra allowances for employees…
  - Strict control of budget implementation (some steps have already been made, but they should be strengthened further)

Quarterly budget implementation goals

- Fulfillment of 2013 goal depends primarily on strict expenditure control
- Therefore, we propose defining quarterly goals…
  - ...with automatic entry into force of measures if goals are not fulfilled
- Basic quarterly goals would relate to the amount of total republic budget expenditure
  - And specific goals – expenditure related to goods and services and subsidies
  - Fiscal Council could assess the fulfillment of those goals independently
  - While automatic measures would be related to pension and wage indexation, limitation of subsidies…
- Still, it is crucial – to make an arrangement with the IMF

Fiscal Strategy defines good goals

- Public debt crisis has not been avoided yet
- Fiscal Strategy defines a good deficit path until 2015
  - It reduces public debt share in GDP as of 2014
  - It implies deficit reduction by expenditure decrease exclusively
- But, in order to reach the targeted deficit in 2014 thereby, reforms need to be launched in 2013
- Problem – structural reforms have not been developed enough
  - Provide a more concrete description of measures, list the laws and decrees which will be implemented, justify the savings and define clear deadlines for all the above mentioned
- It is necessary to upgrade the Draft Fiscal Strategy

Crucial medium-term expenditure reforms

- Pension reform
  - Actuarial penalties of 6%, gradual increase of age limit for women
- Employment and wage reform
  - Rationalisation of redundant staff (education, health care, local self-government), better control of payment and employment (central register), simplification of wage classes system
- State-owned and public enterprises reform
  - Significant reduction of number of enterprises undergoing restructuring, introduction of efficiency criteria for individual public enterprises
- Subsidies system reform
  - Upgrade of business ambience instead of providing subsidies, limitation of guarantees
- Social welfare reform
  - Social cards
- Tax administration reform and curbing gray economy
- Establishing a sustainable fiscal decentralisation system

Employment and wages (Trends)

- Faster public sector wages growth must be stopped as planned by indexation stipulated by the law
  - From 2010 to late 2012, public sector wages increased by 11.4% more than stipulated by the indexation
  - Even in 2013: envisaged wages indexation of around 4.5%, while the 2013 Budget Law stipulates even 7% growth rate
  - Significant irregularity: in 2012 and 2013, within the item “social expenditure for employees”, there are around RSD 6 billion allocated annually for extra wages of Ministry of Interior staff

Employment and wages (What has been done)

- Limitation of expenditure meant for employees (with pensions) will make crucial savings in 2013.
- Limitation of top wages and unifying wages for ancillary jobs
- Ban against new employment within budget beneficiary institutions without the approval of the Ministry of Finance
- Abolition of a (small) number of agencies, but without savings (of a greater scale)
- Employee register announced
- “No dismissals during the crisis” (2013?)

Employment and wages (Necessary reforms)

- Until the end of 2013, a single system of wage classes should be introduced (12 to 15)
- In the course of 2013, a program of rationalisation of employees should be developed , including local self-government level
- Allocate employees within different sectors of state administration and public services

Fiscal decentralisation

- Disturbed system solution from 2007:

- 15 bil 2009, lower transfers Republic - local self-government

+ 40 bil 2011, local self-government gets 80% of income tax

- 5 bil 2013, abolishment of quasi-fiscal fees

= 20 bil

surplus in local self-government and deficit on the republic level

- Surplus in local self-government is spent irrationally
  - Increase in wages and number of employees, goods and services, subsidies
  - The lowest growth of capital expenditure in local self-government

Fiscal decentralisation

- A great share of 20 billion will be “irreversibly” lost unless the imbalance between the republic level and local one is settled in 2013
  - Transfer of competence from the republic level to the local one
  - Bringing back a portion of funds from the local level to the republic one
- Transfer of competence takes time and preparation
  - Failed attempt to transfer 4 billion of liabilities for roads to local self-government this year
  - It cannot make necessary savings in a short period of time

2013 Budget proposal

- 4 billion for road maintenance to be financed by local self-government instead of Republic

- Reduce the transfers to the local level by RSD 7 billion
  – Revoke transfers to developed towns

  – Belgrade: 70% of income tax, no transfers
  – Developed towns: 80% of income tax, <u>no transfers</u>
  – Others: 80% of income tax + transfers

System solution proposal

- Re-introduction of the 2007 Law
  - 40% of income tax + 1.7% of GDP of transfers
- Amendments to the current Law
  - 80% of income tax + 0.5% of GDP of transfers
- Transfer of additional competence to the local level
  - It takes time and detailed planning
- Without a system solution, decentralisation will have a negative effect to economic growth
  - Already seen in a great number of countries undergoing transition