Republic of Serbia
Fiscal Council

ASSESSMENT OF THE BILL AMENDING THE LAW ON THE 2014 BUDGET OF THE REPUBLIC OF SERBIA- EXECUTIVE SUMMARY -

The 2014 budget revision is the first step in a three-year programme of fiscal consolidation. The large and growing fiscal deficit and public debt indicate that the current state of public finances in Serbia is unsustainable. An additional problem that threatens to completely undermine the public finances of Serbia is poor performance of public and state-owned enterprises and domestic banks. The cost of poor performance of these enterprises eventually becomes the burden to the state, directly or indirectly. This situation requires a complete shift in the conduct of fiscal policy, but also in the management of public, state-owned enterprises and banks, because the alternative is a crisis of public debt - a drop in GDP of around 10%, high inflation, depreciation of the dinar and a big drop in living standards.

The proposed budget revision indicates that the country's actual deficit in 2014 will amount to RSD 300 billion although a much smaller value is presented in the Bill. The Bill amending the Law on Budget (revision) formally projects the country's deficit in 2014 in the amount of RSD 225 billion, but it does not include (although it should) all the expenses borne by the Republic of Serbia as a result of poor performance of state-owned and public enterprises and banks, or certain expenditures financed from project loans. If all these expenses were included in the revised budget, the deficit of the Republic of Serbia would exceed RSD 300 billion. The Fiscal Council considers that all government expenditures, in particular those relating to public and state-owned enterprises, should be clearly presented in the 2015 budget. Thus, the scope of government expenditure incurred by poor performance of its enterprises would be much more transparent, and it would also be clear to which extent the current state of public finances in Serbia is unfavourable. In addition, this would give the National Assembly an opportunity to discuss all of the expenditures and not just those presented in the bill.

Solving the problem of public and state-owned enterprises is essential for the recovery of public finances, but there are still no tangible positive developments. Although the revised budget deficit does not include the largest part of the government spending on the poor performance of its enterprises, we may conclude, on the basis of indirect information, that these expenditures have been on the considerable increase. Hence, in 2014 the state spent over RSD 9 billion of direct subsidies for Srbijagas (presented in the budget, formally through budget loans), over RSD 17 billion for servicing the existing debt of Srbijagas ("below the line", not presented in the budget), and on top of all that, the revision envisages the approval of the guarantees for new borrowing of Srbijagas, by the end of the year, in the amount of USD 200 million. Therefore, in 2014 Srbijagas directly costs the country about EUR 230 million and by the year end it will create new debt of more than EUR 150 million (new loan guarantees), which the state will most probably be paying off. The future status of Zelezara Smederevo, which costs the state about EUR 100 million a year, was not solved in the first half of 2014 although it was announced at the time of adopting the 2014 budget. The current state spending on public and state-owned enterprises is unsustainable even neglecting, a risk that it could increase even furtherif the poor performance of EPS is to be covered from the budget. We draw a particular attention to this risk as, if realized, it could sink the public finances because of the sheer size of the enterprise. The recent announcements of the highest state officials stating that a solution will be found in due course for certain loss-generating enterprises are encouraging, and the Fiscal Council believes that the problems of almost all public and state-owned enterprises must be resolved systematically and decisively, and that (when the budget funds are allocated for them) they should be transparently included in the budget and deficit of the Republic of Serbia.

The budget revision has increased the Republic of Serbia's deficit by about RSD 40 billion, but the Fiscal Council assesses that this increase could, however, be somewhat less. The reasons for the deficit increase are partly objective (changes in the macroeconomic environment, floods), partly a result of failure to implement the planned policies (shortfall of budgeted revenues from combating shadow economy), and partly a consequence of poor budgeting (failure to incorporate all the subsidies). The deficit increase in 2014 compared to the plan would be even greater if the state had not been very inefficient in the execution of public investment. In the first nine months of 2014, only 40% of the amount budgeted for public investment was spent. It is because of such poor execution of public investment that we believe that the degree of their execution will be considerably lower even compared to the revised (reduced) plan, so that the Republic of Serbia's deficit will most likely be about RSD 10 billion less than projected in the revision.

The projected revenues of the Republic of Serbia have been reduced in the revised budget by about RSD 33 billion - and we consider it reasonable. In comparison to the original Law on Budget, the biggest shortfall is recorded in the revenues from VAT and excise tax, while the revenues from corporate profit tax is slightly higher than expected. The VAT revenues are over RSD 30 billion less than expected, mainly due to objective circumstances, i.e. due to changes in the macroeconomic environment. In fact, in drawing up the budget, it was projected that the economic growth would be 1% and the average inflation would be about 5%. Instead, the GDP will be a negative 1%, while the average inflation will be between 2 and 2.5%, resulting in less revenue from VAT. The originally planned higher revenues from VAT included also the optimistic expectation that shadow economy would be suppressed in 2014, which has not happened. The level of VAT collection has remained practically unchanged compared to 2013, which shows that (in terms of collecting VAT) fiscal discipline remained at approximately the same level as in the previous year - i.e. that shadow economy has neither increased nor has it been reduced. However, the growth of shadow economy is most likely the reason for the decrease in excise tax revenues as compared to the plan (by RSD 15 billion). In fact, we have noted two divergent trends in collecting excise tax: 1) somewhat higher growth of collected excise taxes on oil products deriving from the tax base changes, which indicates that shadow economy in the market for oil products was reduced in 2014, and 2) a strong shortfall of influx from excise taxes on tobacco products, which indicates further growth of shadow economy in this market. Better collection of corporate profit tax (increased by RSD 8 billion) is primarily the result of the real appreciation of the dinar in 2013, which (formally) increased the profit of many enterprises in Serbia. The revenue projections shown in the revised budget are in line with their movement in the first nine months of 2014 and expectations of the Fiscal Council.

The total amount of the Republic of Serbia's expenditure planned in the revised budget is close to the original budget, but their structure has worsened. Although at first glance the total expenditure in the revised budget of the Republic of Serbia does not significantly differ from the initial budget, a more detailed analysis of its structure reveals a considerably less favourable situation. As already pointed out, not all the funds planned for investments will be used (the Ministry of Finance estimates this amount at RSD 4 billion, and the Fiscal Council at around RSD 15 billion), but other than that, the original budget planned about RSD 15 billion to be spent on the severance pay for employees of enterprises in restructuring. Therefore, if the state had been efficient in the implementation of its planned (and justified) policies, the total expenditure of the Republic of Serbia would have exceeded the revised budget by more than RSD 20 billion. Looking from another aspect, one could say that the expenditure of the Republic of Serbia is actually considerably higher than it was planned at the beginning of the year, but that it is not apparent, because of inefficiently executed public investment and delayed resolution of the status of enterprises in restructuring.

Spending on various subsidies has significantly increased, which can be very dangerous in some cases. The increase in subsidies compared to the original budget is a consequence of poor budgeting, but also of new expenditures arising throughout the year. Although the state owes the banks about RSD 8 billion for subsidised liquidity loans, and owes the amount of RSD 1.6 billion to recyclers, this debt was not included in the initial budget for 2014 and, consequently, it now appeared as additional expenditure in the revised budget. We attribute that part of subsidy increase to poor budgetary planning. The remaining increase in subsidy is mainly a consequence of poor performance of state-owned enterprises. In this group, we highlight the unplanned allocations for Srbijagas amounting to over RSD 9 billion. At the beginning of this year, the National Assembly was dissolved due to early elections, and Srbijagas was unable to take the planned guaranteed loan of USD 200 million. For that reason, in the first half of the year an emergency state subsidy (in the form of budget loan) was approved to Srbijagas in the amount of over RSD 9 billion to cover its insolvency. However, Srbijagas should (when certain technical requirements for taking the guaranteed loan are fulfilled) return the money to the state, but that will not happen - the budget revision confirmed the state-guaranteed loan for Srbijagas in the amount of USD 200 million, but the repayment of debt to the state has not been planned, which in fact means that the Republic of Serbia has additionally spent over RSD 9 billion in 2014, thus exceeding all planned amounts. Another worrying subsidy of about RSD 2 billion is the one that the Republic of Serbia gives to the GSP Belgrade (city public transport company). The Fiscal Council considers that financing the poor performance of a local enterprise from the state budget could be a dangerous precedent. In addition to the aforementioned, there has been a considerable increase in state subsidies for PE Resavica, RTS and others.

The state expenditures for the payment of fines and damage compensations have been increased in the budget revision by over RSD 5 billion. The state payments of fines and damage compensations based on court decisions have more than doubled in the revised budget and now amount to RSD 10 billion - a quite material item on the state balance sheet. This claim can be illustrated by the fact that the amount presently paid by the state for fines and damage compensations equals the total solidarity tax collected in 2014. There are different reasons for unacceptably high fines and similar expenses. Obviously, there is a lack of discipline in the state activities in terms of compliance with laws, procedures and contracts, resulting in the situation where national and international courts more and more often issue decisions in favour of individuals and companies that are in dispute with the state, and also determine the payment of increasingly larger amounts. For example, in many cases the state failed to complete preparatory activities for investment (land expropriation and other), and consequently the contractor could not perform its work and filed a lawsuit against the state (the highest fine of RSD 1.6 billion in 2014 derives from the unexecuted contracts related to concession). Along with enhancing the accountability of government agencies, it should certainly be examined whether the public attorney's offices take all necessary actions, completely and efficiently, to prevent damage to the state (for example, filing an appeal).

The most important fiscal measure proposed in the budget revision is the reduction in pensions and public sector salaries. The bills on temporary regulation of pensions and salary base pay for the users of public funds envisage the following: 1) linear cuts to public sector salaries by 10% (which excludes all employees with a salary below RSD 25,000), and the abolition of the current "solidarity tax" and 2) progressive cuts to pensions by 22% on the amount of pension in excess of RSD 25,000 and 25% on the amount of pension in excess of RSD 40,000. Annual savings that will be achieved by implementing this measure amount to approximately EUR 400 million. The reduction in pensions and public sector salaries is the first and necessary measure to avoid the crisis of public debt and therefore it is welcomed by the Fiscal Council. However, in addition to cutting salaries and pensions, in order to avoid the crisis, it is necessary to solve the problems of public and state-owned enterprises, reduce shadow economy and implement structural reforms (employment downsizing in the public sector, introduction of fairer wage bill system, etc.). We would like to draw attention to the fact that the Fiscal Council assesses that the recovery of public finances requires the reduction of fiscal deficit by at least EUR 1.6 billion in the next three years, which means the savings of nearly EUR 2 billion (because some expenses will increase in the coming period). Therefore, it is in this context that we should assess the pension and salary cuts - they provide EUR 400 million of the required savings in the amount of nearly EUR 2 billion. This means that the government will face a huge challenge over the next three years to ensure the additional savings of over EUR 1.5 billion without revisiting pensions and public sector salaries, which is absolutely the largest item of public expenditure.

The Fiscal Council assesses positively the proposed model for salary cuts. The proposed salary cuts of 10% will yield substantial fiscal savings; it will not increase inequity in the current system of public sector salaries (although the existing salary system should be reformed) and it is comprehensive because it includes the public enterprises and other public sector entities that are not part of the general government (and whose salaries are, as a rule, much higher than average). The 10% salary cuts will still not be sufficient to establish a sustainable level of government spending on salaries in the short term, but the economically justified level of government spending on salaries could be reached by consistent application of other measures, primarily employment downsizing, in the next three years.

The proposed model of pension cuts is not an optimal option; it implies a sharp and progressive reduction in pensions, which results in relatively small savings . Pension cuts are inevitable in the present situation of Serbia's public finances. The Fiscal Council understands the reasons for the government's decision to exclude from reduction all pensions below the average (25,000 dinars), which account for about 60% of all pensions. However, it is fair to point out the cost and risk of this model for pension cuts. The pensions somewhat above the average will be relatively sharply cut, and the overall government spending on pensions will, nevertheless, be reduced by only 5% (spending on salaries will be reduced by about 10%). It also means that, even after this reduction, the pensions will still remain at a level that significantly exceeds the economic power to finance them. In the middle of the year, a good pension reform law was adopted, increasing the fairness of the pension system and leading to a gradual reduction in government spending on pensions, but its full positive effects will be felt only in the long term and mainly neutralised by unfavourable demographic trends.