Republic of Serbia
Fiscal Council

# SUMMARY OF THE REPORT "EVALUATION OF THE FISCAL STRATEGY 2014-2016 AND DRAFT 2014 BUDGET"

**The seriousness of the public finances situation in Serbia demands more decisive measures than those stipulated by the Budget Law and the Fiscal Strategy.** The 2014 planned deficit of 7.1% of GDP (€2.4 billion) is too high, there are still no visible developments and a clear plan for solving the problems in the biggest money losers (Srbijagas) and the medium-term adjustment plan is not supported by the measures which could result in desired savings. The room for successful fiscal consolidation in 2014 and in the coming years is now so small that halfway, *ad hoc* solutions cannot bring even temporary improvements, let alone permanent sustainability of the Serbian public finances. Therefore, the Fiscal Council considers: 1) that the planned 2014 budget is inadequate and that additional savings of 0.8-1% of GDP are necessary; 2) that order must be brought in the operations of public and state-owned companies and banks which spend huge budget funds immediately and that further uncontrolled outflow to them must be stopped; and 3) that structural reforms, such as a pension reform, must be adopted as soon as possible and a completely credible plan of medium-term savings must be made, since 2014 is only the first year in the three-year programme of strong fiscal adjustments. So as to verify such a plan (if made) on the international level, we think it is crucial to make a new arrangement with the IMF.

**Additional savings of 0.8-1% of GDP should be made in the 2014 budget.** Planned deficit of the consolidated state of 7.1% of GDP is the biggest one in the whole Eastern and Central Europe and it has grown by around 0.5% of GDP in comparison to 2013. Although the Government announced the adoption of a package of measures for fiscal consolidation of at least 2% of GDP in October, the true range of proposed measures is almost twice as low – only 1-1.2% of GDP, which is not sufficient to stop the growing deficit in 2014. Therefore, the Fiscal Council thinks that additional savings of 0.8-1% of GDP (around €300 million) in the 2014 budget are necessary (and viable). In such a way, not only the announced Government objective from October would be realized, but, more importantly, the 2014 fiscal deficit would be decreased if compared to 2013. There are indications that some of these savings will be proposed by the Government as amendments to the Draft Budget Law during the Assembly procedure. An Additional and substantial deficit decrease in 2014 is the first imperative condition for fiscal consolidation.

**Problems in public enterprises and state-owned banks which use budget funds uncontrollably must be put on the table without delay**. Unsuccessful operations of public and state-owned enterprises and banks from previous years will cost the state around 1.7% of GDP (€600 million) in 2014. The settlement of these liabilities will be precisely the main reason why the 2014 deficit will grow instead of getting lower, despite the introduction of the solidarity tax to wages exceeding RSD 60,000 and the increase of the lower VAT rate from 8 to 10%. More adversely, public enterprises and the banking sector are expected to make new losses/liabilities to the state of at least €630 million which will be covered after 2015. Therefore, it is quite reasonable to ask – how useful are wages and pensions reduction and tax increase if these savings are *a priori* spent for Srbijagas, Železara Smederevo

(Smederevo Steel Mill), failed banks, Galenika, etc? Coming to grips with problems in public enterpises and state-owned banks urgently is, therefore, the second imperative condition for fiscal consolidation, since, without it, any fiscal adjustment would be pointless. However, the latest hints indicate that all these problems may not be solved so fast. The case of the far biggest money loser in the state – Srbijagas - is an indicative example – announced restructuring in the company is turning into a political issue. Without underestimating considered ownership and organisational and legal issues, the Fiscal Council is of an opinion that the first task in Srbijagas restructuring process has to be the change in the operations of this company implying that it will not get budget funds any further, neither temporarily, nor on a one-off basis.

**Although, in principle, the medium-term plan sets good goals in terms of deficit reduction in general, the measures to achieve this are unbalanced and, therefore, uncredible enough.** The Fiscal Strategy stipulated the reduction of the state deficit (including off-budget financial transactions) in 2015 and 2016 by almost 4 percentage points (pp) of GDP, i.e. from 7.1% of GDP in 2014 to 3.2% of GDP in 2016. If the starting point would be lower (2014 deficit lower than 6.5% of GDP), such deficit reduction in 2015 and 2016 would be adequate. Nonetheless, the measures behind this reduction are not convincing. The biggest savings (around two thirds of total savings) are planned in the field of benefits for public sector employees and refinancing an expensive public debt by a cheaper one. However, the savings in the area of salaries were overestimated since they imply the reduction of salaries and employment level which is almost unfeasible. The replacement of an expensive public debt with a cheaper one would imply that all (or almost all) accrued funds from still precarious privatisation revenues and a more favourable bilateral borrowing are used for early repayment of an expensive credit and for cheaper deficit financing. The Fiscal Council considers that instead of such a risky and unbalanced structure of medium-term savings, it would be much more rational and more credible to plan *pro rata* savings in most of budget items (pensions, subsidies, non-targeted social benefits, etc.), not only in two of them. In this context, at least from the point of Government credibility, we think that it is very important to initiate the pension reform which has been repeatedly postponed for a year now.

**The crisis can be avoided only if all the three imperative conditions are complied with.** We have already highlighted that the room for crisis avoidance has got smaller. Therefore, the public, as well as the political office-holders, should get prepared for additional and painful savings measures during the whole period between 2014 and 2016 (along with bringing order in public enterprises and state-owned banks without delay). This is the only way to reverse the course of the growing public debt in 2017 – even then, only relatively (compared to the GDP), while, in nominal terms, public debt will continue growing even after 2017. We would like to stress that annual borrowing of around €5 billion for deficit financing and repayment of principal of the existing public debt will be necessary during the whole consolidation period. This is why the Fiscal Council thinks that it is essential to make an arrangement with the IMF which would be the guarantee for creditors to continue borrowing funds to Serbia until it copes with its fiscal problems. A possible slightly cheaper borrowing in 2014 (€3 billion credit from the United Arab Emirates), with possible higher privatisation revenues present a mitigating circumstance for 2014. Nevertheless, at the same time, it is dangerous since it may result in the postponement of the implementation of necessary measures. Therefore, the Fiscal Council calls for responsibility, even in terms of public statements, since quick and easy solutions, such as the idea of collection of €1,5 billion from grey economy, cheap state borrowing of great scale for financing a wide variety of development projects, etc. – do not exist. The seriousness of the situation Serbia is facing is similar to the one in Greece or Portugal, the countries which have implemented a deficit reduction programme over many years. Finally, we would like to highlight that the adjustments have to be made in Serbia in the coming period and that the only choice one can make is whether adjustments will be lower and controlled (during the three-year period of painful and politically unpopular measures) or uncontrolled (via production drop of over 5%, high unemployment growth, strong RSD depreciation and high inflation).

**Consolidated state deficit of RSD 285 billion (7.1% of GDP) which is planned in 2014 is too high.** This deficit has two parts. The fist part includes the planned deficit of all levels of authority (Republic, local level, mandatory insurance funds, Putevi Srbije (Serbian Roads)) amounting to 5.5% of GDP (RSD 219 billion). The second part, which amounts to 1.7% of GDP (RSD 67 billion) includes the state liabilities, incurred due to unsuccessful operations of public and state-owned enterprises and state-owned banks. In comparison to 2013, the state deficit is increased by around 0.5% of GDP, since the 2013 deficit is expected to reach 6.6% of GDP (with liabilities „below the line"). As opposed to the previous period, the Fiscal Council does not have many objections to the realism in public revenue and public expenditure planning. Although we have noticed some risks in both areas which may lead to deficit overstepping the limit, there is an objective possibility that some other revenues may overstep the plan and/or all planned expenditures may not be fully realised. Although there is no dispute with the Government about the level of down-to-earth approach to the fiscal deficit evaluation in 2014 this time, the fact that the planned deficit is too high still stands.

**Planned Government measures in 2014 do not include adjustments of over 2% of GDP as it was announced in October, but only 1-1.2% of GDP.** The very Government resigned the proclaimed adjustment of 2% of GDP in 2014 and reduced the objective to 1.65% of GDP in the Fiscal Strategy. However, true savings will be even lower. The only „firm" measures from the Government package which will reduce the deficit for sure are those with regards to the increase of the lower VAT rate and solidarity tax, which will bring around 0.85% of GDP altogether. Still, the savings arising from subsidies are presented single-sidedly in the Fiscal Strategy. Namely, it is true that the subsidies to companies are planned to be reduced by around RSD 12 billion (0.3% of GDP) and the Fiscal Council supports this, but there is one fact missing, i.e. as of 2014, RTS (Radio Television of Serbia) and RTV (Radio Television of Vojvodina) will be financed from the budget subsidies instead of subscription and that will requre contributions from the budget of RSD 7.5 billion (0.2% of GDP). For this reason, the Fiscal Council estimates that the true savings with regards to subsidies is the difference between the funds which are being saved (economy) and new expenditures (RTS, RTV), i.e. 0.1% of GDP, not 0.3% of GDP as it is given in the Strategy. Another similar case is the expenditure for the procurement of goods and services which will be even increased in 2014 despite indisputable savings with some of budget beneficiaries.

**A big growth of fiscal indiscipline in 2013 endangers the efforts put in fiscal consolidation.** The increase in fiscal indiscipline has actually considerably contributed to the revenues drop in 2013 which can be clearly seen from the analysis of the VAT based revenues. If the tax collection rate in 2013 had remained on the level of 2009-2012, VAT revenues realisation would have been on a higher level by RSD 30 billion, or 0.8% of GDP. An important part of planned fiscal adjustments in 2014, but in the medium term as well, relies on the increase in tax collection – which may not happen. In the package of measures for 2014, the revenues arising from improved tax collection should bring 0.4% of GDP (around RSD 16 billion) and additional 0.5% of GDP in 2015 and 2016. It is almost impossible to say whether this will be the case. There is plenty room for collection improvements – if only Tax Administration would regain the collection level before 2013, not only they could achieve the 2014 goal, but exceed it considerably. However, there are no clear indications that this will really happen. One could hear public explanations which are not quite well-founded that (instead of systemic fight) the grey economy rate will be reduced by „online“ reading of fiscal cash registers or by the presence of free capacities in tax administration upon the introduction of electronic operations in the tax system of Serbia. Similar actions, attractive to media, but not too efficient have already been implemented in 2013 without results – such as fiscal amnesty, especially „zero tolerance“ for tax evasion (after the „zero tolerance“ was introduced, revenues were additionally reduced). This is why the Fiscal Council is still sceptical about the collection of additional public revenues through grey economy reduction.

**Additional savings of 0.8-1% of GDP (around €300 million) should be made in 2014.** The initial Government goal from October 2013 – to adopt fiscal consolidation measures of 2% of GDP – was supported by the Fiscal Council conditionally (if huge state expenditures for Srbijagas and poorly performing state-owned banks are put to an end in 2014). However, the proposed Budget Law for 2014 and the Fiscal Strategy stipulate savings of only 1-1.2% of GDP instead of 2% of GDP. Since, at the same time, in 2014, the contributions for interest rates for the public debt, contributions for the banking sector, Srbijagas, JAT (Yugoslav Air Transport) debt and other liabilities will grow, the state deficit will grow by 0.5% of GDP in 2014, in comparison to 2013, instead of being reduced. The Fiscal Council thinks that additional savings of 0.8-1% of GDP (around €300 million) are necessary since, thereby, the initial objectives announced in October 2013 would be realised and the 2014 fiscal deficit would be reduced in comparison to 2013.

**Bad management of public enterprises and banks will cost the state around €560 million (RSD 67 billion) in 2014 and it will create at least €630 million of additional liabilities which will be repaid as of 2015.** In 2014, the state will spend €560 million for the settlement of existing liabilities in Srbijagas, former JAT, Galenika, Železnice Srbije, Železara Smederevo and probably for some interventions in the banking sector. Additional funds of at least €630 million are actually new state guarantees which will be issued in 2014 for the borrowings of Srbijagas, Železara Smederevo, Železnice Srbije and the Deposit Insurance Agency (since it spent their funds for interventions in banks). Since these companies/institutions cannot repay the credits from their own operations fund – once the first installment is due (2015), the state will assume the settlement and, thereby, the deficit will be increased as of 2015.

**Srbijagas has debts towards banks of over €800 million, a debt towards NIS (Petroleum Industry of Serbia) of €224 million and, they will arrange an additional debt of €200 million in 2014 – all this is covered by the state.** Longstanding unsuccessful operations of Srbijagas will be transfered to tax payers in the coming years. Servicing Srbijagas debts in 2014 and in the coming years will cost the state over €150 million annually – this does not even include new debts which will be certainly made in 2014 by this company, NIS liabilities and other possble operating liabilities which are still not publicly known – the annual cost of the state in terms of Srbijagas will be certainly even higher. We would like to stress that the total annual savings arising from the introduction of solidarity tax amount to around €100 million which means that the reduction of salaries in the whole public sector in 2014 will not be sufficient to cover the costs of the state allocated to only one public enterprise in 2014. As an additional illustration of annual costs of Srbijagas which will be covered by the state in 2014, but during the coming years as well, we can also compare them with the total planned state contributions for science which will amount to less than €140 million in 2014.

**The Fiscal Council has indicated the problems in the operations of Srbijagas for almost two years now – in the meantime, these problems escalated, instead of being solved.** The first time we pointed out the problem of the growing volume of guarantees for the borrowings of public enterprises (Srbijagas being one of them) was in February 2012. In May 2012, in the study Draft Measures of Fiscal

Consolidation, we analysed the problems in the operations of public enterprises in detail, Srbijagas included. We would like to highlight that the debt of this enterprise amounted to around €400 million at that moment. In the meantime, instead of having problems solved, they were growing further and the libilities of Srbijagas got almost tree times higher. The increase in the volume of guarantees for Srbijagas was the exact reason for the cancellation of the arrangment with the IMF for precautionary reasons in early 2012. At least in principle, the Government started paying more attention to this problem in 2013. Accordingly, in June 2013, Srbijagas was included in the Programme of Measures for the Public Sector Reform: *„Srbijagas will have to cover all their liabilities on their own, without the state aid via new credit arrangemenents“.* Nonetheless, fairly soon, the Draft 2014 Budget Law included guarantees for additional €200 million of borrowings to supprot the liquidity of this enterprise, and the state fully assumed servicing Srbijagas liabilities which are due in 2014.

**Total costs of state interventions in the banking sector from 2012 till 2014, with 2014 included, amount to around €800 million.** These funds are used for recapitalization of poorly performing banks, different financial transactions during the mergers between unsuccessful banks and more successful ones, including the disbursement of secured and unsecured deposits (which were covered by the funds of the Deposit Insurance Agency). The Fiscal Council would like to point out that the problems in the banking sector are not solved and that the amounts used for this purpose are extremely high in balance terms and that, taking all into account, the funds will keep outflowing in 2014 as well.

**Without solving the problems in unsuccessful state-owned banks, Srbijagas, and numerous other unsuccessful state-owned companies – fiscal consolidation is impossible.** The difficulties the Ministry of Economy is facing during the process of settling the fate of the companies undergoing restructuring are clear enough to demonstrate the size of the problem the Government will have to face. Coming to grips with the biggest problems in terms of balance genuinely and, in political terms, (in some cases, social terms) probably the most difficult problems – Železara Smederevo, Srbijgas, unsuccessful state-owned banks, Železnice Srbije, Resavica, Dunav Osiguranje (Dunav Insurance), Galenika, etc. – is expected as late as in 2014. The plans adopted and signed by the Government (Fiscal Strategy) stipulate that most of the above mentioned problems should be solved even during 2014. The Fiscal Council emphasizes that it will not be possible to implement the fiscal consolidation and avoid the crisis unless the issues of state-owned, public enterprises and state-owned banks are not solved.

**The Government objective to reduce the fiscal deficit in 2015 and 2016 by almost four percentages of GDP – is a good objective.** The reduction of the fiscal deficit and solving the problems in state-owned companies and banks in 2014 is only the first step in necessary medium-term fiscal adjustments. If the fiscal deficit in 2014 gets reduced to the level of 6-6.3% of GDP instead of the currently planned 7.1% of GDP, additional – further deficit reduction by 3.9% of GDP by 2016 would lead to the 2016 deficit of below 2.5% of GDP. Such deficit course would put a stop to the growth of the public debt share in GDP in 2016 and reverse its course in 2017. On the other hand, it implies very strict measures for deficit reduction not only in 2014, but in 2015 and 2016, too.

**The measures proposed by the Goverement so as to achieve the medium-term objective are still underdeveloped.** The measures for the increase in public revenues were exhausted (the increase in the higher VAT rate, and, afterwards, the lower one, profit tax) and this is why medium-term fiscal adjustments are possible only on the expenditure side of the budget. To that end, the Government adopted a decision to reduce the standard indexation of public sector pensions and wages during 2015 and 2016 to only 1% annually – which, along with expected inflation of about 5%, would bring real reduction of contributions for pensions and wages. However, this is not even close to the level which could bring the planned budget savings. This is why in Fiscal Strategy envisaged big savings, especaially in terms of expenditures for employees and interest rates (since a replacement of an expensive debt with a cheaper one is planned). Nevertheless, we estimate that the first measure is not well-designed, while the second one remains uncertain.

**The Fiscal Council thinks that the basis for medium-term fiscal savings needs to be expanded.** It is little likely that the key Government measure for medium-term adjustments – reduction of contributions for wages – will bring the planned savings. Simulations of the Fiscal Council show that, so as to achieve this, it would be necessary to reduce the wages nominally (with solidarity tax) in the end of 2014, as well as to reduce the number of employees in the public administration. Taking into account the experience from the previous several years when wage freeze faced great resistance, while unplanned *ad hoc* layoff of public sector employees was more harmful than beneficial – we consider such measures almost unfeasible. Therefore, the Fiscal Council thinks that a more balanced allocation of the medium-term savings burden to different budget expenditure items (pensions, agricultural subsidies, the structure of which should be improved, subsidies for public enterprises – Železnice, Resavica, non-targeted social contributions, etc) would have much better prospects and would be far better in economic terms. We estimate that it is particularly important to start the implementation of the pension reform which has been announced several times at last (introduction of the system of actuarial righteousness and the increase in the age limit for women to 63 years).

**The public debt will most likely exceed 70% of GDP in the years to come.** In the end of 2013, the public debt will amount to around 64% of GDP and it will continue growing in the coming years since there is no way to reduce the fiscal deficit at a short-term to the level which provides a reverse in the public debt course (around 2% of GDP) and to quit issuing guarantees for the borrowings of public enterprises. We estimate that the reduction of the public debt share in GDP can be expected in 2017 at the earliest, but only if all the three critical conditions for fiscal consolidation are met: 1) to make additional savings in 2014 of 0.8-1% of GDP, 2) to stop the uncontrolled outflow of budget funds towards public enterprises and banks and 3) to improve planning and implementation of medium-term savings measures and initiate structural reforms (pension reform, etc.).

**Fiscal consolidation has to be implemented so as any kind of economic growth could be expected in the coming years, but the fiscal consolidation itself is not enough.** In order to increase the economic growth potential in the future, reforms directed at the improvement of business environment are important. First of all, they include: finalisation of restructuring in former socially-owned companies in 2014, increased efficiency in the issuance of construction permits, as well as the amendments of the labour legislation which were announced by the Government by the end of 2013. One must not forget that, in developed economies, public enterprises are a very improtant driver for GDP growth, especially thanks to their investments. This is why it is important from this point of view to change the manner of public enterprises management so as they could create economic growth instead of making losses.