Republic of Serbia
FISCAL COUNCIL

FISCAL DEVELOPMENTS IN 2014 AND BASIC RECOMMENDATIONS FOR BUDGET REVISION AND MEDIUM-TERM ADJUSTMENTS 2015-2017

Summary

The risk of imminent crisis requires urgent implementation of fiscal consolidation - the government no longer has much of a choice or possibility of further delay. Since its establishment in 2011, the Fiscal Council has been warning of the unsustainability of fiscal policy and major imbalances in the public finances of Serbia. The measures implemented in the meantime, in response to the bad situation of public finances, were insufficient, selective, short-term and often poorly prepared - and the most painful ones were usually softened or postponed. At the same time, new problems emerged even faster, as well as new costs, the largest of which were those related to the poor performance of domestic banks, public and state-owned enterprises and the growth of grey economy. These problems have caused an additional large and unsustainable fiscal expenditure that has increased the country's deficit and public debt. Thus, in 2014 there is a huge deficit of over 8% of GDP and the public debt that will exceed 70% of GDP at the end of the year. These indicators show the need for urgent implementation of comprehensive fiscal consolidation, given that a public debt crisis is an absolutely certain alternative.

Fiscal consolidation is based on three pillars: 1) bringing order in public and state-owned enterprises, 2) reduction of unsustainable spending on pensions and public sector salaries, 3) structural reforms - and all three are necessary. The fiscal cost of the *poor performance of public and state-owned enterprises* is a large and fastest growing state's expense, which threatens to completely undermine public finances. Without solving these problems, any fiscal consolidation is bound to be a failure, because all the savings would flow out (as they have so far) to cover the poor performance of public and state-owned enterprises. The Serbian economy is not able to finance the current level of *spending on pensions and public sector salaries*. The sustainable level of spending on pensions is about 10% of GDP and on public sector salaries about 8% of GDP, whereas currently nearly 14% of GDP is allocated for pensions and nearly 11% of GDP for salaries. The reduction of unsustainable spending on pensions and public sector salaries is not only economically needed, but it is the only way to achieve the necessary substantial decrease in fiscal deficit - especially in 2015, because all other measures can yield first tangible results only in two to three years, and some of them even later. Therefore, pensions and public sector salaries should immediately be cut by 15%. The reduction of deficit in the medium term (2016 and 2017) will crucially depend on the structural reforms whose foundations are being set now. The Fiscal Council fully supports the adoption of reform amendments to the Law on Pension and Disability Insurance, the first steps that lead to the necessary downsizing in the public sector (amendments to the Law on Labour, the Central Registry of Employees) and the reduction of grey economy (legislative changes, personnel improvements of Tax Administration). The beginning is

promising, but the major and most difficult part of this reform package (downsizing of employees) remains to be carried out.

The 2014 deficit will be approximately over 2.6 billion euros (8.3% of GDP). The public revenue and expenditure trends in the first six months indicate that the planned (large) fiscal budgetary deficit of about 2.5 billion euros will not only be reached, but also exceeded. The planned revenues will fall short by about 50 billion dinars, but savings will be achieved on expenditures in the amount estimated at about 30 billion dinars. The main reasons for having a deficit larger than planned are the objective circumstances of changed macroeconomic environment (lower inflation, recession) due to which the public revenues have decreased, and to a lesser extent, the impact of floods (deficit increase of around 0.2% of GDP). The deficit of 8.3% of GDP is the highest in Europe (except maybe in Ukraine), which is a valid indicator of the unsustainability of Serbia's current fiscal situation.

The large deficit is a structural problem that cannot be solved without strong measures of fiscal consolidation. In the course of 2014, the Ministry of Finance has succeeded in maintaining the biggest fiscal expenditures, especially salaries, below the planned budgetary framework (which was not the case in the previous years). Moreover, a decline in public revenues was mainly the result of objective circumstances and not the result of poor control or increased grey economy (which happened in 2013, for example). Nevertheless, the deficit is huge and growing, which means that the fundamentals of public finances have been inappropriately established, and not that the lack of discipline in the budget execution has increased. The problems in the public finances are structural, and not operational, because the state has been spending, systematically and for many years, even 15-20% more funds than collected. This means that the problem of large fiscal deficit will not and cannot be eliminated without strong budgetary measures and difficult political decisions. The publicly raised arguments according to which the economic recovery would solve the problems of public debt and deficit; or the variation of this argument according to which the reduction of public expenditure (pensions and salaries) is not expedient, because it will reduce spending and tax revenue to such extent that it will have no impact on the deficit – are not based on quantitative analyses and can mislead citizens into believing that there is an easier way by which unpopular measures can be avoided.

The goal of fiscal consolidation is to reduce the deficit to below 3% of GDP in 2017 and stop the growth of public debt. The fiscal deficit and public debt cannot grow and cannot be financed indefinitely. Having its public finances in such a state, Serbia must annually borrow around 5 billion euros to finance the deficit and pay the due debt - and this debt continues to grow year by year. The state's annual borrowing need has already exceeded 15% of GDP, which is the standard threshold that indicates an increased risk of insolvency. The performance of the state's basic functions (payment of pensions, financing of health care, education, defence, social welfare, etc.) largely depends on the loans of international investors and their trust that Serbia will be able to repay the borrowed money in the future. If the public debt is constantly growing (the state incurs more and more debts) and there is no credible plan for changing the situation in the foreseeable future – at some point the investors will stop lending money to the country and there will be a crisis. Therefore, it is necessary to implement fiscal consolidation in order to align the state's expenditures with its capabilities and stop the increase of public debt-to-GDP ratio as soon as possible (by 2017). The Fiscal Council also considers that it is necessary to make a new arrangement with the IMF, which would be an additional guarantee to investors for the implementation of planned consolidation.

It is necessary to save nearly 2 billion euros through fiscal consolidation by 2017. By 2017, the fiscal deficit should be reduced from the current amount of over 2.6 billion euros (8.3% of GDP) to less than 1 billion euros (3% of GDP). However, during this period, some state's expenditure will have to grow, such as the payment of interest (due to the growing public debt) and public investment (which is presently insufficient). Consequently, the deficit reduction of 1.7 billion euros over the next three years will require the savings of nearly 2 billion euros. It is impossible to achieve all those savings either without touching pensions and public sector salaries, which are absolutely the largest items of public expenditure, or without stopping the huge funds outflow due to the poor performance of state-owned and public enterprises.

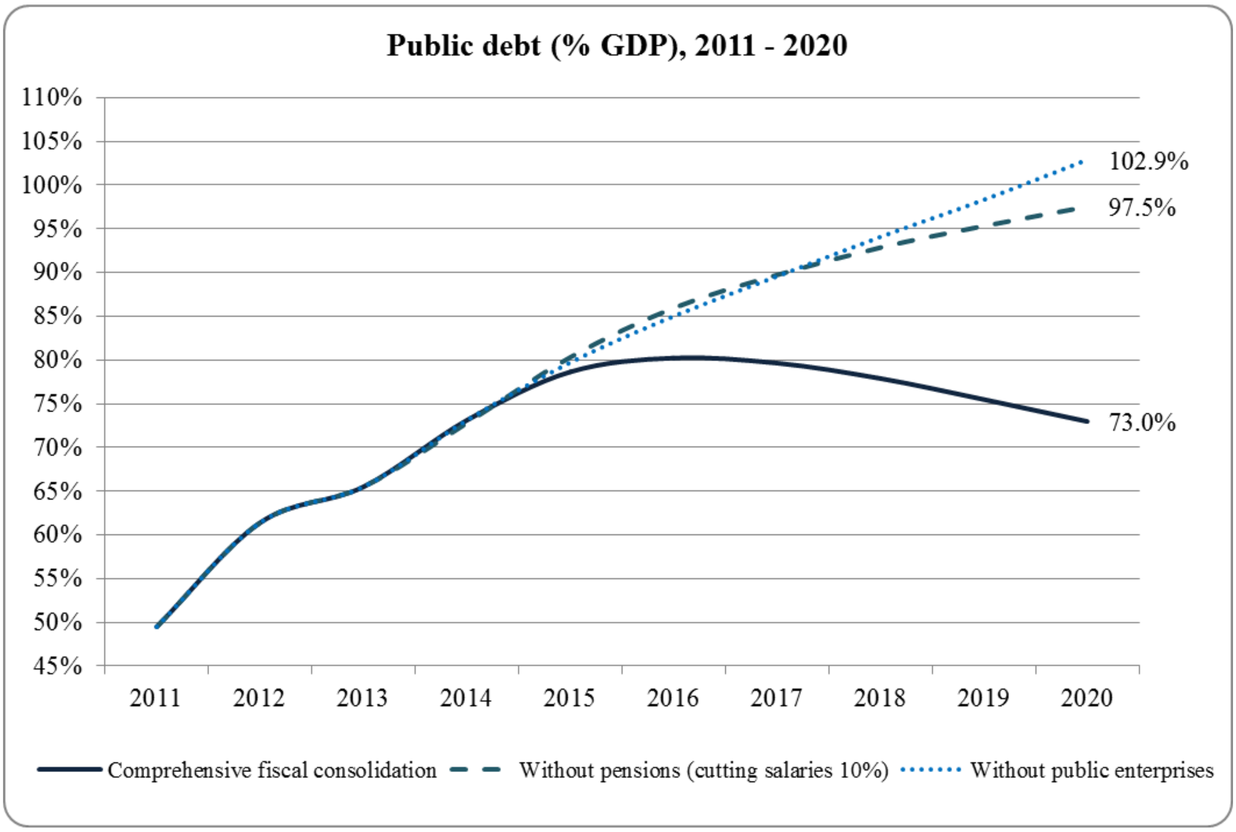
The state currently spends about one billion euros annually because of the poor performance of state-owned and public enterprises and by 2017 that cost should be reduced by 400 to 500 million euros. The huge expenditures of public and state-owned enterprises threaten to sink the public finances of Serbia, and in 2014 the problems have been additionally increased. Currently, the biggest risk is that the poor performance of the largest state enterprise, EPS, will become a fiscal cost. If EPS becomes unable to service its obligations on its own, it will probably devastate the public finances of Serbia completely, due to the scope of the problem, and make fiscal consolidation impossible. Srbijagas continues to generate losses, as it does not collect any payments for the gas it delivers to state owned companies (Azotara, Petrohemija, MSK etc.), heating plants and many others. Instead of resolving the future status of Zelezara Smederevo in the first half of 2014, as announced and budgeted, the state has now restarted production in that enterprise and increased the fiscal cost. In addition, there is a risk that some of the state-owned banks will require fiscal intervention. The problems of public and state-owned enterprises are political (interest groups, party management) and professional (overstaffing, low prices of products, poor collection of payments, technological backwardness, negative selection within enterprises and many other weaknesses), which means that they cannot be eliminated overnight, and in some cases, fiscal costs probably cannot be completely avoided (for example, subsidies to Railways). The Fiscal Council has assessed that bringing order in public and state-owned enterprises could result in the fiscal savings of 400 to 500 million euros by 2017, and that the most important measures for achieving that are the restructuring and resolving the future status of the enterprises to which the state issues guarantees for borrowings and covers debts in other direct and indirect ways.

It is necessary to cut pensions and public sector salaries by 15% immediately at the time of budget revision. The savings from pensions and salaries are critical to the success of fiscal consolidation, since they produce not only the biggest fiscal effects (about 800 million euros from cutting pensions and salaries by 15%), but it is also the only measure of fiscal consolidation that will have its full effect as soon as in 2015. No other measure can have its maximum effects before 2016; some measures cannot have their maximum effects even then. We emphasize that about 70% of the total savings on salaries and pensions would be achieved by cutting pensions, which means that it is absolutely impossible to make the required savings without having to reduce pensions. Those who receive minimum pensions and salaries would be protected and exempted from reduction. Therefore, the reduction of salaries and pensions by 15% is the largest and fastest fiscal measure, and it is economically justified - because it eliminates the major structural problem of public finances (unsustainable percentage of GDP). However, from the perspective of political economy, it is certainly the most difficult of all the measures. All these facts indicate that this should be implemented immediately – at the time of 2014 budget revision.

In the medium term (2016 and 2017), the structural reforms (employment and salaries in the public sector, pension reform, combating grey economy, etc.), whose foundations are being set now, will have a decisive impact on deficit reduction. Structural reforms are the third necessary factor of fiscal consolidation because in a few years they will give the remaining 700 million euros of savings - if they start immediately. To put it simply, the implementation of structural reforms is another name for better state organisation. For example, it is not justified that the workers who retire at the age of 60 and those who retire at the age of 65 (after the same length of service) receive the same pension benefits, because the former will receive pension 5 years longer on average; that the state as an employer does not fire an employee whose performance is low; that the administrative employees in some agency receive several times higher salaries than those working in some of the ministries; that the company that pays its fiscal liabilities competes in the market with another company that is exempt from such liabilities (or operates in a grey area). Although the first fiscal effects of the implementation of these reforms will be visible only after two or three years, their foundations are being set at the present time. Therefore, in addition to the already adopted laws on pension and disability insurance and on labour (supported by the Fiscal Council), it is essential, by the end of the year, to develop plans for public sector employment downsizing, continue with efficient legislative change, reform the Tax Administration and inspection services, etc. Further delays would result in the failure to sufficiently reduce the fiscal deficit in 2016 and 2017, which could again require new painful short-term measures in those years.

The temporary adverse impact of fiscal consolidation on the economy can be considerably mitigated by a coordinated fiscal and monetary policy. The biggest fiscal deficit adjustment of more than 3 percentage points of GDP (from 8.3% of GDP to 5% of GDP) would take place, according to the Fiscal Council's proposal, in the first year of fiscal consolidation, because the most effective fiscal measures - cutting pensions and salaries by 15%, would be implemented by that time. The strong deficit reduction in the first year of fiscal consolidation (*front-loading*) is a rule in almost all cases of successful fiscal consolidation. Such adjustment is important for the credibility of the entire programme, because after achieving a much smaller deficit, the entire fiscal consolidation becomes less risky - which will be rewarded with a greater confidence of investors. However, one of the consequences of the strong adjustment of deficit in 2015 is a possible temporary adverse impact on the economic activity, since the reduction of fiscal deficit by about 3% of GDP could lead directly to the 1% drop in GDP. For that reason, fiscal consolidation should be implemented in a package with other well-thought out measures of monetary and fiscal policy, which would be aimed at encouraging the economic growth. Otherwise, if the economic policies remained uncoordinated, a dangerous combination could easily occur: recession and deflation and unsuccessful adjustments. The measures to be implemented along with fiscal consolidation are: 1) structural measures for the improvement of business environment and growth, such as already initiated improvements of labour legislation, the Law on Planning and Construction, etc.; 2) increasing the scope and efficiency of public investments (which have much higher fiscal multipliers than other forms of public spending). This group of measures includes the enhanced activity of the country's reconstruction after the floods, which could mitigate a substantial part of potential short-term adverse effects of fiscal consolidation on the economic growth; 3) adequate measures of monetary policy to prevent the beginning of deflation and growing illiquidity in the economy. Besides, short-term, well-targeted and inexpensive fiscal and credit incentives, if carefully designed, could significantly help in the implementation of fiscal consolidation with a minimum adverse impact on the economy in 2015.

Chart: Projection of public debt with the comprehensive and incomplete fiscal consolidation



- It is futile to cut salaries and pensions without solving the issue of public and state-owned enterprises (·····), and it is insufficient to solve the issue of public enterprises without cutting salaries and pensions (----); it is necessary to do both (─).

- In order to stabilise the public debt, it is necessary to make the savings that correspond to those achieved through cutting salaries and pensions by 15% as soon as in 2015
    - smaller reduction of salaries and pensions would require additional adjustment measures, most probably further tax increase – a worse economic solution.

Table: Overview of the key measures of fiscal consolidation

	Possible savings (million EUR)	Time of full effect	Current situation	Risks
Public and state-owned enterprises	400 – 500	Next 3 to 4 years	Unfavourable – problems are rapidly increasing instead of decreasing	High – professional (plan and downsizing of employees, appropriate prices, collection of receivables, technical improvements and investment, etc.) and political (interest groups)
Cutting salaries and pensions by 15%	800	2015	Pending political decision	Low – possible exemption from salary cuts for individual public sector categories
Combating grey economy	300 – 350	Next 2 to 3 years	Initiated personnel changes in the Tax Administration, some positive effects are already noticeable: increased collection of contributions and excise tax on oil products, decreased revenue from cigarette excise taxes	Moderate – presently on the right track, but major challenges still lie ahead
Reforms (of earnings and employment, pension reforms, etc.)	300 – 400	Next 2 to 3 years, longer for pension reform	Adopted the reform Law on Pension and Disability Insurance; the central registry data are being prepared; beginning of the salary grade scale reform announced for autumn; there is no information about downsizing plans at the local level, in the sectors of health care, education, state administration, etc.	Low – for pension reform Moderate – for salary grade scale High – for redundancies
Total	≈ 1,900	By 2017	Unfavourable – trends of deficit, enhanced problems of public enterprises Favourable – still low interest rates, political environment	The highest risk – bringing order in the business operations of public enterprises

(Note: The reports of the Fiscal Council can be downloaded from the website www.fiskalnisavet.rs)