Republic of Serbia

FISCAL COUNCIL

OPINION ON FISCAL STRATEGY FOR 2019 WITH PROJECTIONS FOR 2020 AND 2021

Summary

The Fiscal Strategy has been missing its main mark for years - to serve as a credible, strategic document for medium-term public finance management. Fiscal Strategy should be the most important document for the implementation of medium-term fiscal policies. Hence, it should comprise the following elements: 1) objective identification of the country's most pressing economic issues and needs; 2) clear definition of fiscal policy objectives and strategic guidelines for the best response to these challenges and 3) quantification of all these measures and policies and their inclusion in medium-term forecasts. The Budget System Law therefore prescribes that the first Fiscal Strategy Draft should be adopted significantly earlier than the Budget (as early as in April) so that the budget for the following year (which is prepared in the second half of a year) would be prepared in line with well thought-out medium-term fiscal policies. However, the Budget Calendar has not been respected since 2012 as adopting of the Strategy mostly coincided with the annual Budget. Hence the Strategy has been derived from the Budget, instead of vice-versa - which makes the Strategy moot. For a number of years, the Fiscal Council has been criticizing the violation of these procedures and a lack of suitable medium-term policies in practically all of the analysed Strategies thus far. Up to 2017, perhaps there could have been some understanding for these omissions of the Government, as the public finance stability was at risk and the priority was to put out that fire, i.e. to avoid a public debt crisis. Since 2017, as the threat of a crisis has subsided and public debt has been put under control, there is no longer any justification for "year to year" fiscal policies, with frequent changes in priorities and without clear strategic goals. Hence, the Fiscal Council once again invites the Government (as we have done last year, as well) to respect the legally prescribed budget procedures and the spirit that they serve from 2019 onward. The waste of high-quality resources that the government has at its disposal in the Ministry of Finance on elaborating Strategies purely for formal purposes, without sufficient credibility and impact on fiscal policies can no longer be tolerated.

The adopted Fiscal Strategy plans for an adequate general government deficit in the medium term; however, the Strategy fails to respond to the greatest public finance challenges. The adopted Strategy has its positive sides. Its most important positive element is the fact that the low fiscal deficit of 0.5% of GDP (planned in the 2019 Budget) is permanently maintained in the years to come. The planned general government deficit at the level of 0.5% of GDP is suitable for Serbia in the medium term, as it leads to a further decrease of the share

of the excessive public debt in GDP. According to the forecasts in the Strategy, the public debt should fall under 50% of GDP in 2020, which is a realistic forecast and a good result, bearing in mind that at the end of 2015, the public debt had exceeded 70% of GDP. However, except for the suitable public debt trajectory and budget deficit, the majority of other economic and fiscal challenges that the Government should respond to by 2021 has not been adequately addressed in the Strategy, while some major issues are not even mentioned at all.

- *Firstly,* the Strategy fails to recognize Serbia's most pressing macroeconomic issue - structurally (lasting) low economic growth. For that reason, even the medium-term budget forecasts fail to recognize the need for changes in fiscal policies that would contribute to the acceleration of economic growth (increase of investments in infrastructure, a greater reduction of the fiscal burden on labour after 2019 etc).
- *The second* issue, somewhat related to the previous one, is the extremely poor state of Serbia's basic infrastructure (roads, railroads, and especially environment protection) - which should also be addressed in the medium-term with properly targeted public investments increase.
- *The third* issue pertains to the low quality of services provided by the government in key areas such as healthcare and education (which were poorly evaluated in the relevant international surveys), but also in terms of the Tax Administration which has been evading modernization for a number of years now. The best response to these issues is a credible reform plan of the aforementioned large government systems, with clearly defined measures and deadlines. In addition, some wider public sector reforms can also be classified here - first of all, improving the management of the number and structure of public employees (preparing quality job catalogues instead of the current employment ban) and introduction of economically fair pay grades for all general government employees.
- *The fourth* issue pertains to the disordered state of public finance at local government level. Unlike the central Budget which, following consolidation is stable - local government budgets are still plagued by numerous issues and, in some towns and municipalities, are not sustainable at all. The Government, however, plans no systemic or strategic approach in the Strategy for this issue in the medium term, which would substitute the current practice of *ad-hoc* directing considerable funds from budget reserves to local governments with failing finances, with no clear criteria.
- *Fifth,* poor business performance of public and non-privatized state-owned enterprises is an important topic that the Strategy fails to treat in a satisfactory manner.

The largest macroeconomic issue in Serbia is the insufficient economic growth. In terms of economic growth rate, Serbia is lagging behind comparable Central and Eastern European countries (CEE). From 2010 to 2018, the cumulative growth of Serbia was about 15% and, on average, CEE countries had double this growth (30%). Due to insufficient economic growth, living standard in Serbia lags further and further behind comparable countries - according to the last available data for 2017, GDP per capita in Bulgaria was higher than that in Serbia by a third, in Romania by about 50% and in Poland about twice as high. Economic gap between Serbia and comparable countries continues to grow in 2018, even though Serbian GDP growth (which we estimate to 4.3%) will match the CEE country average exactly. Namely, about 1 p.p. of Serbian economic growth is owed to agricultural recovery from the 2017 drought. Without it, economy would have grown by about 3.3%, which would have been among the lowest growth rates in Central and Eastern Europe. The main structural issue that has significantly slowed down Serbian growth over the entire last decade, compared to the growth of other CEE countries, lies in insufficient investments (both of the public and of the private sector). Share of investments in Serbian GDP, since the start of the economic crisis in 2009, dropped below 20% of GDP and was the lowest in the post-crisis period compared to other CEE countries (on average, 17.5% of GDP in Serbia compared to 22% of GDP in CEE). In order for Serbia to achieve and maintain an economic growth that is at least 1 p.p. faster than CEE average (which would allow for catching up, in terms of development) - the share of investments in GDP should amount to about 25%. However, this share - even with a certain increase - will only amount to about 18.5% in 2018 and Serbia will, all things considered, probably continue to lag behind comparable countries in 2019 as well (Serbian GDP is forecast at 3.5% while CEE countries will most likely see an economic growth of over 4%).

Adequate fiscal policy could have a significant impact on a sustainable acceleration of Serbian economic growth. Fiscal policies in the medium term need to be modified to provide for the necessary investment increase and the consequential economic growth acceleration. *Firstly*, the government can have a direct effect on the growth of overall investments and GDP growth acceleration through a large increase in infrastructure investments - by over 1% of GDP in medium term. Public investments have by far the largest fiscal multiplier (positive impact on economic growth) compared to all other types of public expenditure (salaries, pensions, subsidies etc). Hence, their increase would significantly accelerate economic growth, starting with construction works (construction companies, work force, mostly home-made materials). At that, an increase in government's investment in infrastructure would improve the quality of infrastructure and create better conditions for doing business, i.e. even in the long-term, it would have an important effect on economic growth acceleration. *Secondly*, implementation of public enterprise reforms (primarily of EPS) and privatization of the remaining state-owned enterprises would also lead to the necessary increase in their investments, which we estimate at about 1% of GDP at least. *The third*, and largest, part of the necessary investment increase to about 25% of GDP pertains to private sector investments. Even though these are private investments, the government plays an important, if not even pivotal, role in this segment too. One of the good measures for the stimulation of private investments is in a larger decrease of the fiscal burden on labour in the years to come, allowing private enterprises to increase their price competitiveness and have more funds available for investments. In addition, to promote private investment, the government should start implementing measures to improve those components of the business environment that have been given lowest marks by the relevant international institutions (decreasing corruption, rule of law, increase of public administration efficiency, strengthening institutions etc).

In its Strategy, however, the Government plans no changes in fiscal policies aimed at the necessary acceleration in economic growth - first of all, there is no public investments increase. Fiscal Strategy actually doesn't recognize the insufficient economic growth as a major structural issue in Serbia. On the contrary, the current GDP growth has been assessed as strong and dynamic, with the Government taking most of the credit. Since the issue has not been properly recognized in the Strategy, appropriate policy measures are also missing. In the medium term the share of public investments in GDP remains unchanged, at the level of about 4% of GDP - instead of increasing to about 5% of GDP by 2021, which would be their adequate level for Serbia. In addition, the reform of the largest public enterprises is both inadequately represented in the Strategy and not credible. A special strategy (which would encompass an integrated approach to monitoring and supervising the performance of state-owned and public enterprises and the process of their financial consolidation) planned for adoption in 2019, could potentially lead to stepping up public enterprise reform in the medium term. However, there is insufficient detail in the adopted Fiscal Strategy to clarify the purpose and content of this new document. Finally, fiscal forecasts in the medium term (forecasts of contributions and income tax) indicate that there will be no further decrease of the fiscal burden on labour, despite the Government's announcement that the decrease of the fiscal burden on labour from 63% to 62% in 2019 is just the first step in further relaxation in the upcoming years.

A significant public investments increase is not only necessary for economic growth acceleration, but also because of the very poor state of infrastructure. Due to many years of low investments in environment protection, Serbia is among the most polluted European countries - which represents a serious hazard for health and decreases the average life expectancy of its population. It is a devastating fact that even the largest cities in Serbia - Belgrade and Novi Sad - still have no wastewater treatment plants, so the sewers directly discharge into the surface water (Sava and Danube). In addition, the quantities of collected household waste are also inadequate, while recycling and waste treatments are a true rarity; therefore, almost all waste is disposed of at landfills (which frequently fail to satisfy even the basic sanitary standards) with no treatment. Many settlements in Serbia have no safe drinking water, while approximately 2.5 million citizens live in areas with overly polluted air, which represents a health hazard. The quality of road and railroad infrastructure is not at the adequate level either, despite somewhat accelerated development and reconstruction of roads and railroads in recent years. The main roads (Corridors 10 and 11) are still not complete and the deadlines for their completion have been breached countless times. Hungary, Croatia and Slovenia have as much as 2-3 times more kilometres of highways (expressed as km per 100,000 population) than Serbia. In addition, as much as two thirds of railroads in Serbia have not been electrified, while the speed of trains cannot exceed 60 km/h at more than a half of the railroads. The Fiscal Strategy has failed to recognize any of these issues - or provide good answers to them by modifying fiscal policies in the medium term. Instead, the Strategy lists basic principles, such as "renewable energy sources and environmental investments remain in constant focus while defining future activities", which does not even closely resemble the facts - and the fact is that the government's investments into these areas have been unacceptably low both in the previous years and in the 2019 Budget.

Poor general government employment management exacerbates the already low quality of important services offered by the government to its citizens. The Government has no concrete plan as to when it intends to shift to a sustainable general government employment management model and finally revoke the harmful employment ban. A sustainable employment management model would actually mean the implementation of reforms that would accurately determine the number of employees - and qualifications of such employees - needed for each individual sector in the government. Concretely, for healthcare, this would mean: Defining the overall number of staff, the ratio of medical vs. non-medical staff, employment structure by specific qualifications (various specialists, general practice), optimal geographic distribution of doctors and hospitals, ratio between the primary, secondary and tertiary healthcare etc. For education, this would mean: Overall number of the necessary teaching staff, their educational profile, optimal geographic distribution of schools, optimal number of students and classes per teacher, with rationalisation of the school network etc. However, regardless of the numerous announcements in the previous years, the Government has failed to implement such reforms and elaborate good systemic job catalogues; instead, general government employment management is handled through a general employment ban (together with a Committee for issuing consent for new employment in urgent cases). General government employment ban had been introduced back in December 2013 as an interim measure, with the original validity term by the end of 2015; however, each following year, the ban was extended, ending with 2019 - and perhaps it will remain in force in the upcoming years as well. Prolonging the employment ban practically means that the already major issue of the lack of employees in healthcare, various inspections, parts of ministries charged with EU project implementation etc. will not be resolved, which certainly affects the very poor quality of basic services provided by the public sector to the Serbian citizens (as assessed by the relevant international institutions).

It remains to be seen whether the salary system in the general government will be regulated by the introduction of uniform, economically just pay grades in the upcoming years. The process of regulating the general government salary system has been going on for four years now, with no concrete results - in fact, in the meantime, the general government salary system has been additionally set back by *ad - hoc* salary increases by individual ministries, which have been implemented since 2016 and have been planned for 2019 as well. What experience from previous years has shown is that the Government must change the unsuccessful approach it had taken thus far if it means to resolve the issue. Instead of pandering to the demands of the most numerous and most influential sectors and their unions, when determining pay grades it is important to respect clear and concrete economic criteria, with which this reform will make sense in the first place. The Fiscal Council has written about such criteria several times over the previous years; we dealt with this issue in greatest detail in a separate study that the Fiscal Council published in the first half of 2018. In short, the pay grade system must apply to the entire civil service. The practice thus far that saw the adoption of individual laws for different segments of the civil service sector and postponement of inclusion of the police, army and some other parts of the public sector in the unique pay grade system, jeopardizes the integrity and the purposefulness of the reform process. Secondly, the minimal salary base in the civil service sector needs to be matched to the minimal wage at the national level. This will avoid meaningless pay grade coefficients leading to salaries lower than the minimal wage guaranteed by law. Thirdly, salary parity for different jobs in the general government must be determined according to economic (and market) parameters. Relating to that, the range between the lowest and highest salary in the public sector could increase from the current 1:7.5 to 1:12 (as is the case in European countries) so that the most qualified and most essential employees, who are able to get far better conditions in the private sector, would not be leaving the civil service sector. Fourthly, a detailed register of employees and their salaries (including all bonuses), comprising all general government jobs must be compiled and published as soon as possible - something that other European countries have (e.g. Slovenia).

Local government budgets are still disordered and there is no systemic solution for this problem on the horizon. Local government budgets are incomparably lower than the central budget; therefore, their individual issues are often given lower priority when deciding on fiscal policies. However, local government finances have a significant impact on economic growth and quality of life of Serbian citizens - which is why it is very important for the Fiscal Strategy to devote some attention to them, which has not been the case so far. Many local governments are defaulting on their liabilities due to the poor state of their budgets; this passes the problems of the local governments down to the economy, especially the centrally-owned public enterprises. The systemic shortage of investments is another way in which poor local finance management is hindering GDP growth - the annual shortage of public investments of local governments amounts to about 300 m Euros. These funds, instead of being spent on the necessary investments, are used to cover the losses of locally-owned public enterprises, which get enormous subsidies of over 200 m Euros per year. At that, the long-term lack of local government investments has a devastating effect on the quality of life of Serbian citizens. By the quality of public utility infrastructure (access to safe drinking water, sewerage coverage, waste treatment), percentage of children enrolled in pre-school institutions and numerous other indicators, Serbia is lagging far behind comparable CEE countries. The Fiscal Council has dedicated a comprehensive study to the issues of local governments and their public enterprises in mid-2017, providing concrete recommendations to the Government for the resolution of these issues. Since then, the situation has somewhat improved, first of all in the decrease of defaults (debts) of local budgets, but the important reason for this lies in Government interventions - approval of special transfers from budget reserves for the most at-risk local governments. In the previous three years, local governments have been granted about 100 m Euros in assistance, from the budget reserves (which are approximately a third of the regular, legally defined annual transfers from the central to the local level of government); this amount will probably be additionally increased in the final days of 2018.

Analysis of the budgets of four largest cities in Serbia indicates issues in their public finance management that cause concern. For the purposes of this report, the Fiscal Council has analysed budgets of four largest cities in Serbia - Belgrade, Novi Sad, Niš and Kragujevac - which together form a half of the local public finances and in which a third of the Serbian population lives. We had also analysed these same cities in mid-2017. The analysis shows that there is certain regularity in public finance management at the local level, which is somewhat reminiscent of the central budget. The primary objective in all observed cities was to ensure budget stability and sustainability, but as a rule, no efforts were made past that point, i.e. no reforms of public enterprises, measures of increasing revenue collection or increase of investments into communal infrastructure were implemented. Cities with budgets that had already been stable, Novi Sad and Belgrade, did practically nothing to further improve their public finance. The largest of all issues, the financially unsustainable public transport in Belgrade, has escalated further and the costs of public transport covered from the city budget have increased from a little over 120 million euros in 2016 to about 150 million euros in 2018. In both cities, investments are insufficient and in Novi Sad, even significantly lower than in 2016, even though they were too low back then as well. Niš, which successfully implemented budget stabilization measures in 2017 (primarily by increasing the collection of the City’s revenues), halted their implementation as it drew closer to the accomplishment of the basic objective - repayment of all the accumulated defaults (which will probably take place next year). Long-term irresponsible management of city finances in Kragujevac has led to this town having by far the worst budget results in 2016 compared to other analysed cities. However, by 2018, Kragujevac has achieved the most. Debts for electricity and heating have been reprogrammed and original revenue collection has been improved - the collection of property tax has especially been improved (in this case, there was also a justified increase of the tax rate), as well as revenues from the lease of construction land. Kragujevac is still far from a stable budget, but the measures undertaken in the previous two years are promising. Finally, we’d like to point out that all four cities get regular, relatively large sums from the budget reserves of the central budget, which is probably justified as assistance when it comes to Niš and Kragujevac, but it is unclear why the central budget funds are also allocated to Novi Sad and Belgrade.

Privatization of RTB Bor and PKB has marked significant progress in the resolution of the issues of the largest state-owned enterprises; the largest remaining problems are Resavica, Petrohemija and MSK. In 2018, RTB Bor and PKB were privatized while Azotara has (which is justified) filed for bankruptcy. In the meantime, FAP has been brought down to about ten employees (for the refurbishment of military trucks). This decreased the list of state-owned enterprises which, due to their size and poor performance had a significant negative impact on public finance and economic growth (they were getting direct subsidies and other state aid through the Development Fund, were not paying their utility bills etc). The list, however, still comprises: Resavica, Petrohemija, MSK, Ikarbus, Lasta, Simpo, Jumko, Tigar, Trajal. There are about 15,000 employees in this group of enterprises, i.e. about a half of the remaining number of employees in non-privatized state-owned enterprises. Resavica gets 4.5 bn dinar subsidies from the national budget every year, to cover the costs of the workers, meaning that the government is subsidizing every employee in this enterprise with about 10,000 euros. Even though a solution for this issue has been the subject of many of an announcement and funds have been reserved in the budget for a final closure of non-economically viable mines, there is no concrete progress. Petrohemija and MSK had somewhat better performance in 2017, due to the favourable ratio between the input prices (oil and gas) and the final prices of their products. With a new increase of fuel prices, which is sure to come at some point, these enterprises would be unable to operate successfully. Hence, we believe that their fate must be resolved before this happens. If no interested buyers can be found for them, now that the market conditions are very favourable, then they would have to undergo bankruptcy.

Reform of the largest public enterprises practically boils down to Železnice alone, while EPS is still investing less than its depreciation, which could be an obstacle to future economic growth. The three largest public enterprises, EPS, Železnice and Srbijagas took different approaches to the implementation of the necessary reforms. Železnice is the only company that took the reforms seriously. This enterprise was divided into three independent entities - Srbija Voz for passenger transport, Srbija Kargo for freight and Infrastruktura Železnica for infrastructure. The enterprise was downsized from 17,000 to 11,000 employees, the basis for budget subsidies was changed - they no longer include a fixed amount, but they rather depend on measurable criteria and 25% of the railroads that were not economically viable were closed down. These new enterprises now pay their electricity bills and are ready for the next stage of reforms that should rely on the construction and refurbishment of the existing infrastructure, improvement of collection with a review of the prices and introduction of professional management. In terms of reforms in Železnice, it is important that the process is completed so that all of the difficult measures that have been implemented in the last three years will not have been for nothing. Srbijagas had no major changes in the method of operation, but the company has been profitable since 2015 due to the decrease of gas prices on the world market, which significantly increased the collection on the tariffs for the delivered gas (including collection on old debts). For Srbijagas to remain permanently profitable, two measures are key: 1) that the price of gas supplied to public sector be indexed according to the future changes in gas prices and 2) that the gas is not delivered to those who are not paying their bills - which, in practice, would mean that enterprises like Petrohemija, MSK, DP Novi Sad etc. should not be kept alive artificially, if they are unable to pay for the gas from the profits they make. Finally, EPS has the most complex issues, the resolution of which has stalled for a number of years now (excessive expenditures for employees, major losses through the network, non-profitable entities within the system etc). Due to these issues, EPS has not been investing enough for years (investments are lower even that depreciation, which decreases production capacities while EPS should be increasing them). Low EPS investments directly decrease the country’s economic growth; not only that, they can act as a serious impediment to the growth of the economy in the medium term, if adequate infrastructure needed for future growth in industrial production cannot be provided.

Budget calendar legislation needs to be respected and final statement of accounts for the national budget has to be adopted and published. Since 2015, the public has had no information on how the funds planned in the Budget have actually been used, since the Government has stopped submitting Bills on the Final Budget Statement of Accounts to the Assembly since that time. In addition, the Government has not made a credible medium-term plan for economic policy in years, based on which the budget priorities would be defined (i.e. annual budgets drafted). Draft Fiscal Strategy, which should recognize all these priorities, has not been adopted since 2012 within the deadlines defined in the budget calendar; instead, Strategy is drafted at the same time as the Budget. Adoption of the draft final statement of accounts and consistent adherence to the budget calendar are not just elements of good budget practice, they are also the Government’s legal obligation, which is why there is no justification for these procedures not being observed. Hence, the Fiscal Council insists that the Government perform its legal obligations in 2019 in a consistent manner. In addition, the budget process in Serbia has other numerous weaknesses, some of which have even increased in the previous years. Namely, the amendments to the Budget System Law in 2016 and 2017 allowed for the quadrupling of the budget reserve funds which in turn allowed for significant change how the budget funds are used compared to the Budget Law. Here we once again emphasize that both the public and tax payers have been completely deprived of the final statement of accounts for public funds since 2015, so these changes are difficult to see. Furthermore, the latest amendments to the Budget System Law in 2018, also increase the possibility for arbitrary transfer of funds from the central budget to the local governments, since approval of additional non-earmarked transfers to the individual towns and municipalities has been allowed with no objective or systemic criteria.