



Republic of Serbia  
FISCAL COUNCIL

## ASSESSMENT OF THE BILL ON THE 2015 BUDGET OF THE REPUBLIC OF SERBIA

### Executive Summary

**The 2015 Budget Bill envisages a deficit at the central government level in the amount of RSD 191 billion (4.9% of GDP), while the expected deficit at the general government level is higher - about 6% of GDP.** According to the proposed 2015 budget, the envisaged public revenues equal RSD 924 billion, while the expected public expenditure is higher and amounts to RSD 1,116 billion. The expected deficit in the central government budget is, therefore, RSD 191 billion (4.8% of GDP), which is only a part of the total fiscal deficit at the general government level. The reliable information about the budget of all other sectors of general government (funds of social security, local self-government and PE *Putevi Srbije*) has not been publicly available yet. However, it has been estimated that the country's actual deficit may be higher by about RSD 40 billion, thus amounting to over RSD 230 billion (about 6% of GDP).

**The 2015 budget is just a first step in the three-year programme of fiscal consolidation aimed at recovery of public finances and stabilisation of public debt.** The 2015 state budget should contribute to reducing the deficit of the general government by about 1.3% of GDP, i.e. from the estimate of over 7% of GDP in 2014 to approximately 6% of GDP. However, it is just a part of the overall medium-term deficit-reduction plan, which is why appropriate fiscal consolidation measures are required also in 2016 and 2017. Although specific plans of the Government for the medium-term fiscal policy remain unknown (the 2015 Fiscal Strategy with 2016 and 2017 projections has not been published yet), based on the available documents, it is possible to reconstruct the main goals for the next three years. The fiscal deficit in 2017 should be 3.8% of GDP, which is a somewhat smaller reduction than 4% of GDP in the next three years, while the public debt, according to the Government's expectations, would be stabilised at the level of about 79% of GDP.

**The envisaged three-year reduction of budget deficit is not sufficient for the stabilisation and reduction of public debts by 2017 - it requires a more ambitious reduction of deficit or continued consolidation.** The presented fiscal consolidation plans indicate that the adjustments will be less than those required to achieve the main goal of fiscal consolidation, which is stabilising and reversing the rising public debt trajectory within the set deadline. Based on the planned trajectory of budget deficit from 2015 to 2017 and the rate of economic growth on which the Government relies - with reasonable assumptions about the future developments in real exchange rates and real interest rates, we believe that it is not possible to stabilise the public debt before 2018, at the level of over 80% of GDP. In order to make the set target achievable in 2017, the budget deficit should decrease to around 3% of

GDP, which means that the current plan of fiscal adjustment lacks nearly 1% of GDP in additional savings.

**The medium-term economic growth will certainly be lower than anticipated, which makes the public debt stabilisation plan even less realistic.** The forecast decline in economic activity by 0.5% in 2015 has been realistically estimated, but the forecasts of the medium-term growth of 1.5% in 2016 and 2% in 2017 are too optimistic and very difficult to achieve (especially in 2016). The official estimates of economic growth in 2016 are largely based on the significant growth in private consumption, which, we believe, is not based on realistic grounds, and apparently not even possible. Only on the basis of economic growth, which will be lower than anticipated, in 2017 the public debt will come close to the level of about 85% of GDP. We note that the specific measures of fiscal policy in 2016 and 2017 are still unknown and therefore it is not possible to assess the realism of the planned savings in the medium term. There is a risk that, in addition to the forecasts of macroeconomic trends, the total planned reduction in the budget deficit is overly optimistic.

**The lack of timely publication of a medium-term fiscal strategy constitutes a serious breach of budgeting procedures and hinders the provision of an overall assessment of 2015 budget.** According to the Law on Budget System, the Government was obliged to adopt a medium-term fiscal strategy by June 2014. The parliamentary election and setting up a new government, and then the negotiations with the IMF, caused delays in adopting the key document that should define the economic and fiscal policy in the medium term. Consideration of the 2015 Budget Bill without the adopted fiscal strategy is not just a matter of non-compliance with the prescribed budgeting calendar, but it essentially precludes consideration of the proposed budget with respect to fiscal consolidation. In fact, the task of the fiscal strategy is to define the general goals of economic policy, measures for attaining these goals and assessing their effects (taking into account the expected macroeconomic developments) in the three-year period. Therefore, the annual budget should concretise the Government's strategic goals, and it is not possible to give a reliable assessment of the sustainability of economic policy on the basis of budget analysis that does not take into consideration the medium-term framework.

**The two most important measures of structural deficit reduction in 2015 are salary and pension cuts and suspended issuance of new guarantees for covering the losses of public and state-owned enterprises.** Since November 2014, the salaries amounting to more than RSD 25,000 in the public sector, including public and state-owned enterprises, have been reduced by 10%. Pensions have been reduced progressively (the amounts exceeding RSD 25,000 and RSD 40,000 have been reduced by 22% and 25% respectively), which corresponds to their linear reduction of 5%. In addition, it has been planned to reduce the number of employees in the public sector in 2015 by about 5%. From the perspective of public finances, the suspension of the issuance of state guarantees for covering the losses of public and state-owned enterprises still does not bring savings, but stops further growth of budget expenditures on these enterprises. In addition to these vital measures for the permanent reduction of the fiscal deficit, the Government has also envisaged the reduction of agricultural subsidies, the increase in gas transit fees and some changes in the Law on Public Procurement, reducing the privileges of local bidders. All these structural measures together contribute to the permanent reduction of the deficit by around 2% of GDP (up to EUR 650 million).

**As regards the planned employment downsizing in the public sector in 2015, there are no clear plans, methods or criteria, which may hinder the successful implementation of this measure.** According to the plan to reduce the wage bill share in the 2015 budget, the number of public sector employees is to be reduced by about 5% (about

27,000 employees). By far the largest number of employees in the public sector perform necessary and sensitive social functions - education, health and security - which is why reducing their number must be done very carefully. The Government, however, has not yet prepared precise plans, detailed analyses or objective criteria for reducing the number of employees. Therefore, in 2015 this measure will be implemented through natural outflow, i.e. retirement, (with imposing a ban on new employment) and, since this will probably not be insufficient, through layoffs to achieve the set goals. Due to the lack of downsizing plans, these layoffs are not likely to be sufficiently well targeted. Such downsizing measures can have positive effects only in a very short period, and therefore must be of limited duration. The Fiscal Council expects the Government to prepare detailed analyses in 2015, based on which the proper, economically desirable downsizing of the public sector workforce will begin.

**The suspension of new guarantees for financing the losses of public enterprises implies a shift in the short period for Srbijagas and EPS, and privatisation of Železara Smederevo.** The main problems of by far the biggest loss-generator in the country, Srbijagas, are related to the unpaid gas supplied to the domestic petrochemical complex (Azotara, Petrohemija and Metanolsko-sirćetni kompleks). The future status of these three aforementioned enterprises must therefore be resolved in early 2015 or otherwise Srbijagas will soon need new state guarantees. EPS has not been a direct burden on the budget so far, but a noticeable deterioration of its financial performance suggests that this could happen - which would probably sink the Serbia's public finances because of the sheer size of this enterprise. The problems of EPS are extremely complex and are related to: surplus of employees, problems in collecting payments for supplied electricity, losses in the distribution network due to technical obsolescence, as well as theft, organisational problems, low prices, and even floods that had a large negative impact on the performance of EPS.

**The estimates of public revenues and expenditures in the budget are mainly objective, and the expected fiscal deficit is realistic.** The state budget tax revenues are adequately projected, in accordance with the expected trends in macroeconomic aggregates that have a crucial impact on their level (economic growth, private consumption and inflation rate). The mistake made in the preparation of the 2014 budget, when the budgetary projections included in advance the additional revenues from combating shadow economy (which were not collected), has not been repeated, which also contributes to the objectivity of the expected level of tax revenues. The biggest risk for the achievement of the expected amount of public revenue may come from optimistically planned level of non-tax revenue. The anticipated level of budgetary expenditures mainly adequately reflects the undertaken fiscal policy measures (public sector salary and pension cuts) and those planned to be undertaken in 2015 (public sector downsizing, resolving the status of the enterprises in restructuring and problems in Srbijagas, EPS, Železnice, growth in public investment, etc.). In the case of inconsistent implementation of planned measures, there is a serious risk that the budget expenditures may significantly deviate from the planned level.

**It has been planned to increase public revenue by about RSD 30 billion in 2015, mainly due to the expectations of larger non-tax revenue.** A modest increase in tax revenue of about 5 billion is to be expected in view of macroeconomic developments, and is mainly a consequence of the increase in the nominal amounts of excise tax as envisaged by the law. The projected non-tax revenues are about RSD 25 billion higher than those collected in 2014 due to the introduction of duty for mandatory oil reserves (7 billion), expectations of significantly higher profit of public enterprises (around 8 billion), but also the fact that the funds from 10% salary cuts in the part of the public sector that is not under the control of state budget (over 14 billion) will be paid to special accounts of non-tax revenues (local authorities,

public enterprises, NBS). Having in mind that the amounts of dividends paid to the budget by public enterprises in past years have been volatile and usually much smaller, there is a serious risk that the amount of these revenues will be smaller than planned. Due to the unreliable statistics on employment and salaries in public enterprises, it is not possible to make a good assessment of whether the funds from salary cuts will actually be collected in the planned amount of over RSD 9 billion.

**Good coordination of fiscal and monetary policy is crucial for the achievement of budget revenue projections.** The average inflation in 2014 (of about 2%) was significantly lower than the value used for the fiscal projections in preparing the budget for 2014 (5.5%), which was one of the main reasons for the large shortfall in revenues in 2014, of about RSD 30 billion. We consider that the average inflation rate of 2.7%, projected for 2015, is realistic. However, if in 2015 the inflation rate is much lower than the target corridor of NBS (as for most of 2014), the revenues could be significantly lower than projected, and the attainment of Government's fiscal goals could be seriously compromised.

**The planned government expenditures from the 2015 budget are about 6 billion lower than in the revised budget for 2014, with some serious changes in their structure.** The public sector salary spending will be reduced by about 22 billion compared to 2014, due to the wage bill cuts of over 10% (10% of base salary cuts for the amounts exceeding RSD 25,000 and planned employment downsizing). Transfers to compulsory social insurance funds will be reduced by about RSD 6 billion, primarily due to the decline of transfers to the Pension and Disability Insurance Fund as a result of reducing the pension mass by about 5%. The 2015 budget has projected somewhat lower spending on subsidies (mainly due to cuts in agricultural subsidies by about RSD 6 billion), as well as the savings on expenditure on goods and services of about RSD 7 billion. Along with the reduction of a large number of expenditure items, a portion of expenditures will inevitably increase, which in the aggregate will result in a slight decrease in total expenses. Due to the growth of public debt for almost 10% of GDP in 2014, spending on interest has increased by as much as RSD 19 billion. Also, the growth of expenditure on social protection is the result of the plan to solve the situation of the companies in restructuring and consequently, the budgeting for the severance pay for redundant employees. However, the largest expenditure growth is a consequence of methodological changes in budgeting, that is a transparent inclusion of the expenditure equalling RSD 31 billion for the repayment of the activated guarantees of public enterprises, which were previously treated as an expenditure "below the line".

**The repayment of the activated guarantees of loss-generating public enterprises and the budgetary support to insolvent banks has finally been included in the budget in a relatively transparent way.** The Fiscal Council has repeatedly pointed to both methodological and substantial budgeting failure of not including the direct government costs of the poor performance of state-owned enterprises and banks. Explicitly stating the amount of RSD 31 billion allocated for the repayment of activated guarantees for public enterprises is an important improvement of the budgeting process because in the future the budget will realistically reflect the actual level of spending (without hiding certain expenses "below the line"). It is also the main reason why, in spite of the large savings from the salary and pension cuts, the total expenditures were reduced by only about RSD 6 billion compared to the revised 2014 budget. The Fiscal Council has estimated indirectly, by reviewing the individual guaranteed loans granted to public enterprises, that by far the largest part of the planned amount will be spent on the repayment of the loan of Srbijagas (about RSD 19 billion), which is followed by the loans of Železnica Srbije (5 billion) and Železara Smederevo (3 billion), while somewhat smaller amount will be spent on the loans of Galenika and JAT. We consider it justified that, in addition to stating the total amount, the proposed budget in the future

should specify the individual amounts of activated guarantees and respective enterprises. Thus, the National Assembly and the general public would be fully acquainted with the way of budget spending.

**Despite reducing the budgeted amount by about 13 billion, there is no substantial shift in the policy of subsidies, except for the reduction of subsidies in agriculture.** In 2015, subsidies should be lowered by about RSD 13 billion compared to the revised budget. However, bearing in mind that the payment of accumulated arrears for subsidised bank loans in the amount of 8 billion was credited as a subsidy in the revised budget, the actual reduction is only about 5 billion. The reduced amount planned for subsidies is a result of the planned changes in the agricultural producers' entitlement to incentives from the budget (from about RSD 34 billion to RSD 28 billion). We would like to mention that for the realisation of these savings it is necessary, along with the adoption of the Law on Budget, to amend the laws that presently give agricultural producers greater rights, and thus to limit the amount of subsidies and the number of beneficiaries in accordance with the budget.

**There are risks that certain expenditures in 2015 may be higher than projected.** The 2015 budget does not include any funds for state intervention in the banking sector or for covering the losses of public enterprises (such as subsidies for Srbijagas in the amount of RSD 9 billion in 2014). If there is a need for intervention in the financial sector next year (Article 34 of the Budget Bill allows the borrowing of up to EUR 100 million in extraordinary circumstances), the total expenditures will exceed the budget. There are also indications that some of the planned subsidies may be insufficient for the functioning of state-owned enterprises. The subsidies to Železnice have been reduced year after year, without a clear plan for the restructuring of this enterprise, and there is a reasonable concern that the budgeted funds may be insufficient for the payment of salaries throughout 2015. Also, the subsidies to the National Broadcasting Service, although slightly increased, could turn out to be insufficient, bearing in mind that the subscription (which was charged in one part of 2014) was abolished. Unplanned expenses could arise from court judgements and fines to be paid by the state as a consequence of lost cases. During 2014, these expenditures surged by about RSD 5 billion, and therefore we do not exclude the possibility of a similar scenario next year.

**There is a possibility for the expenditures to be lower than budgeted - particularly if the state is inefficient in the implementation of planned policies.** Resolving the status of enterprises in restructuring was planned also for 2014, and the funds necessary for the severance pay were included in the budget. Since the whole process was postponed for 2015, there were budget "savings", but in fact the obligation was only postponed to the following year. Therefore, if the Government is not entirely consistent in completing the process of restructuring, it is possible that the severance pay may be lower than budgeted, again resulting in "savings". However, we would like to mention that it would be in complete contrast with the Government's intentions to improve the domestic economic environment in the shortest possible time. Another risk arises from the already traditionally inefficient execution of public investments. The proposed budget projects the growth of capital expenditures in 2014, but it will require a fundamental change in the execution of public investments. Public investments are unacceptably low and hinder economic growth, and year after year their implementation falls short by as much as RSD 10 - 20 billion.