



Republic of Serbia
FISCAL COUNCIL

FISCAL CONSOLIDATION IN 2015 AND MAIN CHALLENGES FOR REFORMS

Summary

Successful implementation of fiscal plans for 2015 is underway, and it's even somewhat better than planned, but the reforms that are key for a lasting recovery of Serbia's public finance have yet to begin. The first step of fiscal consolidation, resting on salary and pension cut, resulted in the planned state deficit decrease in 2015. This initial result must not be underestimated, especially bearing in mind the experiences of previous unsuccessful fiscal consolidation attempts. At the end of 2012, the state implemented equally stringent measures as those at the end of 2014, but they failed to yield expected results: a significant decrease in tax discipline annulled the effects of the increase of most significant taxes (VAT, profit tax); a slightly larger increase in salaries was tolerated than the (low) indexation prescribed; but the factor that definitely sank the fiscal consolidation from 2012 was the unreformed public sector - primarily public and state-owned enterprises that, through their losses (together with domestic banks), incurred fiscal costs that exceeded the savings achieved. In 2015, the situation is different in many ways: instead of relaxing, the tax discipline has strengthened, so the public deficit in 2015 will be somewhat better than was planned, while salary cuts are now being more consistently controlled. However, the key public finance issues pertaining to public and state-owned enterprises, public administration (healthcare, education, local governments etc) have not been brought under control yet, although certain improvements have been made that lead towards the beginning of their resolution.

The Fiscal Council Report includes, in addition to the analysis of current fiscal flows, an analysis of the implementation of key public sector reforms. Since the first presentation of the Government's fiscal consolidation program for the period to 2017, the Fiscal Council has been emphasizing that the greatest challenges in its implementation will lie in the planned structural reforms: rationalization of the number of public sector employees (together with the reform of the largest public sector systems, healthcare and education), recovery of public enterprises (Srbijagas, EPS, Railways), completion of privatization of unsuccessful state-owned and socially-owned enterprises (with 93,000 employees), reform of Tax Administration and others. In the first half of 2015, it became apparent that such remarks were justified. There are certain improvements, but the start of the implementation of a large number of planned reforms is already running late, some reforms are being attenuated and exceptions are being defined in some cases, whereby previously planned deadlines are being extended (e.g. extension of protection from creditors for 17 strategically significant enterprises). For this reason, the second (and largest) part of this report is dedicated to an objective analysis of the current situation and the perspective of implementation of the most important structural reforms, while the first part of the report deals with current fiscal flows in 2015.

The fiscal deficit could amount to a little under 5% of GDP in 2015, which is a desirable, noticeable decrease in comparison to 2014. In comparison to 2014, the year in which the fiscal deficit amounted to 6.6% of GDP, we expect the deficit in 2015 to drop by approximately 1.8% of GDP. There are four major factors affecting fiscal deficit changes in 2015, in comparison to 2014. These are: 1) a decrease in pensions and salaries in the public sector, 2) tax collection increase (excises and VAT), 3) introduction of excise on electricity and 4) increase of state expenditures for interest payment. The most significant of these is definitely the decrease in the total amount of pensions and salaries in November 2014 (of approximately 5 and 10%, respectively), which decreased the deficit in 2015, when compared to 2014, by 1.5% of GDP. Increase in tax collection is the result of grey economy suppression, primarily in the trade of excise goods and we estimate that this will increase public revenue by 0.5-0.7% of GDP. The introduction of excises on electricity, which will come into effect in August, will lead to a deficit decrease of 0.2% of GDP in 2015. One portion of the savings and increased revenue, amounting to 0.5% of GDP, will however be spent on the increase in public expenditure for interests in 2015, which is an unavoidable consequence of the steep public debt increase from previous years. Taking account of all of the above, we can see that the deficit decrease in 2015 rests on the cuts of pensions and salaries in the public sector, as all other factors almost cancel each other out. If pensions and salaries were to return to their pre-cuts levels, the deficit would also return to the level of about 6.5% of GDP from 2014, as if the consolidation never took place. This is why it is unjustified, from an economic point of view, to open a discussion on their increase (or even their return to the old levels).

Should the fiscal deficit in 2015 drop even lower (below 4% of GDP), it will not be a consequence of additional improvements in fiscal trends, but rather of inefficient implementation of public policy. In the first four months of 2015, only about 15% of the public investments planned for 2015 were implemented, while, as a rule, this usually amounts to a third more (over 20% of the annual plan) in this period. If the realization of public investments is not accelerated by the end of the year, the state could end up with an implementation that is about 1 pp of GDP less than planned. In addition, there is an allocation for about 16 bn dinars in the 2015 budget for severance payments for those employees that will lose their jobs in the process of resolving the status of enterprises undergoing privatization, as well as an additional 8 bn dinars for severance payments for the excess employees in the budget sector. In the first four months of 2015, however, a minimal amount of funds has been withdrawn for these purposes which would, unless something changes by the end of the year, also reduce the deficit in an undesirable way. As realization of public investments and completion of privatization are delayed, not only are the good economic policies planned for 2015 not being implemented, but there is an automatic increase in the state's obligations and deficit in the upcoming years - because the same expenses for severance pays will still be there in 2016, as well as undeveloped roads and other infrastructure. We also include the increased revenue collection from public enterprises (on varying bases) in this group of one-off, economically questionable deficit reductions in 2015, among which the April payment of about 7 bn dinars for certain arrears of the EPS (which is also questionable from the accounting standpoint) into the budget is especially prominent. Although increased withdrawal of funds from the public enterprises into the budget has both good and bad sides, we believe that this manner of deficit reduction is not good in general, since, in addition to not representing a permanent, structural improvement of fiscal flows, it can also lead to damages - taking into consideration the poor situation the state-owned and public enterprises are in, as a general rule.

There is a structural increase of public revenue by about 0.5 to 0.7% of GDP in 2015, due to suppression of grey economy in excise goods trade. The first four months of 2015 were marked by a relatively strong tax and non-tax public revenue increase. While the increase in non-tax revenue represents a one-off injection caused by premature payment of dividends and other special payments from public enterprises (which are not expected in a similar amount by the end of the year), we perceive the increase in tax revenue collection as a structural and lasting improvement of public finance trends. The structural improvement in tax revenue collection is the result of the application of certain grey economy suppression measures, primarily in the field of excise goods (tobacco products and oil derivatives). The increase of excise collection automatically leads to increased collection of the appropriate value added tax - 1 bn of the added revenue from excise tax on average translates into 0.35 bn of additional VAT revenue - so this is the main reason why there is a certain improvement in VAT collection. If similar trends for tax revenue collection continue till the end of the year (which we believe will be the case), a structural increase in public revenue of 0.5-0.7% of GDP would be achieved in 2015.

The planned public spending cuts in 2015 are being achieved, mostly due to the fact that the expenses for salaries and pensions are decreased, as planned. The main reason behind the planned decrease in public expenditures in 2015, compared to 2014, lies in the reduction of state expenditures for pensions of 5% (with their progressive cuts) and salaries, due to their 10% cuts (of income exceeding 25,000 dinars). It is particularly interesting that there will probably be an additional decrease in spendings on salaries that was originally planned to come from budget sector downsizing - regardless of the fact that there will be no mass lay-offs. The reasons for this are: 1) that amendments to the legislation decreasing the payments for the years of service (now only taking into account the years of service with the last employer) were introduced in the second half of 2014; 2) work in shifts, as a salary increment, has been abolished, as have been some other salary increments; and 3) at the end of last year, the workforce outflow through retirement increased (attrition), as they aimed to avoid somewhat more stringent retirement requirements that came into effect at the beginning of 2015 (according to Fiscal Council estimates, this amounts to about 2,000 - 3,000 people).

However, the poor realization of public investments, which has become a chronic issue of Serbian public finances, is a cause for concern. In the first four months of 2015, according to Fiscal Council's estimates, the implementation of public investments is already about 10 bn dinars behind schedule - which, simultaneously, is one of the major contributors to such a low fiscal deficit at the beginning of the year. In February 2015, the Fiscal Council published a comprehensive study on positive economic and fiscal aspects of public investments, but also on the state's extraordinary inefficiency in their implementation. There are indications that the Government has recognized the importance of public investments and that it is taking certain steps to increase them - a special unit was established for public investments realization within the Prime Minister's Office (a *Delivery Unit*), certain organisational and operative changes have been put in place in the Ministry of Construction, Traffic and Infrastructure as well, and the merger of PE "Roads of Serbia" and PE "Corridors of Serbia" has been announced (and is already delayed, according to the schedule announced), aiming to achieve higher efficiency in the performance of infrastructural works. We hence expect an increase in public investments realization by the end of the year that would make up for the delay in the first several months. We would like to point out, once again, that any reduction in the fiscal deficit arising from inefficient realization of public investments should not, under any circumstances, be included among the good results of fiscal consolidation.

The Fiscal Council would like to emphasize the vast state expenditures for interests, which put us among the highest ranking countries in Europe in this negative contest. The price of public debt Serbia is paying is obviously too high - in 2015, the expenditures for interests will amount to over 1.1 bn EUR or 3.5% of GDP and only 6 countries in Europe have higher expenditures for public debt interests. For comparison, Greece, as the country with the highest debt in Europe, with its public debt of 180% of their GDP spends only 0.7 pp of GDP more than Serbia (in addition, the budget spending on interests is expected to reach about 4% of GDP by 2017, which will practically cancel out this difference). Vast amounts paid for interests have already seriously disturbed the structure of state expenditures. For interests alone, which are the most unproductive budget expenditure, in 2015 we have paid more than the total sum planned for public investments, and only slightly less than the total expenditure for education and science (which, together with other associated costs, is sufficient to pay the salaries of about 150,000 employees in this sector).

After 2015, deficit reduction will rest on structural reforms, the foundations of which should be laid in 2015 - but they are running late. Even if it turns out, by the end of the year, that the fiscal deficit in 2015 has been reduced to below 4% of GDP, the true measure of the deficit entering into 2016 will be a high 5% of GDP. The reasons behind this claim have been described above and they pertain to the fact that the main source of any additional deficit decrease in 2015 would come from "bad" savings on capital expenditures and severance payments, as well as from one-off public revenue payments - which will not continue in 2016. Serbian public finances are, therefore, far from recovered and in order to achieve a lasting improvement, the implementation of measures for the reduction of a high fiscal deficit needs to continue in 2016, as well as in the upcoming years. The foundation for deficit reduction in these years lies in the structural reforms that should have already been started, but are running late. Although a permanent solution for the status of state-owned companies in the troublesome petrochemical complex (Petrohemija, Azotara, MSK) was planned for the first half of this year, it has not yet been found; the plan for financial restructuring of EPS was adopted at the beginning of June, instead of in March, with a smaller increase in electricity price than was announced; the Tax Administration transformation plan should also have been ready in March, but has not yet been revealed; the targeted lay-offs of excess employees in the budget sector has not yet begun; and so on. It is good, however, that Serbia has signed an arrangement with the IMF which exerts a certain type of pressure, through its quarterly reviews, not to give up on the planned reforms, however challenging and difficult they may be.

For the realization of fiscal plans in 2016, the announced lay-off of 9,000 superfluous employees in the budget sector needs to take place by the end of 2015. A decrease of 5% in the state spending for salaries has been planned for 2016 and it is one of the main measures for deficit reduction in that year. The factors that reduced expenditures for salaries in 2015 (lower increments for years of service and work in shifts, increased retirement at the end of 2014) will be exhausted by the end of the year, so the planned further reduction in expenditures for employees in 2016 can only be based on a decrease in their number. However, for any savings from downsizing to take effect from January 1, 2016, approximately one half of the excess employees need to be laid off before the start of the calendar year. Otherwise, the planned decrease in spending on salaries in 2016 will not be realized and, consequently, neither will the set fiscal goals. The announcement of the Ministry of State Administration and Local Government that about 9,000 employees of the budget sector will be laid off by the end of 2015 is consistent with this assessment, but we still don't have a precise plan in which sectors and according to which timelines this shall take place (it

was only said that one half of the employees will be laid off from local governments, and the other half at the level of the Republic).

Successful rationalization of the number of employees is only possible if competent Ministries take on the responsibility for its implementation (along with the reforms of their respective sectors). The first analyses of the Ministry of State Administration, published in the "Position Document" have indicated that the largest number of excess employees work in healthcare, police, judicial system and organizations of social insurance (Pension, Health and Labor Fund). However, the downsizing of certain vulnerable sectors, such as healthcare, is only possible if it is performed together with their simultaneous reform. Otherwise, there is a risk of a decrease in quality in certain vital public services and Serbia already ranks poorly in international ranking lists in these fields. It remains unclear, however, if the competent Ministries accept the analysis of the Ministry of State Administration, i.e. if and when they will initiate reforms of their respective sectors, together with the rationalization of the number of employees. The first test that will show if the Government has approached the planned downsizing in a responsible, serious and targeted manner will be the manner in which it will implement the announced lay-offs of 9,000 employees by the end of the year.

Systemic Tax Administration reform are necessary for the suppression of grey economy and a lasting increase in public revenue. The extent of grey economy in Serbia, together with Bulgaria and Romania, is the highest in Eastern Europe and is estimated to amount to over 30% of GDP. Although certain improvements have been made in 2015 in tax revenue collection, the efficiency of the collection (monitored through the *C-efficiency* ratio) is still very low, even compared to 2012. We estimate that systemic, decisive measures against grey economy could lead to a lasting increase in budget revenues of about 300-250 million Euros. The Fiscal Council believes that the correct way of reaching this target lies in an in-depth reform of the key segments of tax administration and not, as was the case so far, in the *ad hoc* approach. In this regard, it is essential to implement a reform of Tax Administration, which would include the rationalization of its organisational units, development of a comprehensive and contemporary information system, capacity building and adequate distribution of employees by sectors and other measures. It is therefore important to adopt and implement, consistently, an adequate Tax Administration reform plan, which is, after all, a part of the arrangement with the IMF.

Unreformed public and state-owned enterprises represent the highest risk to a successful fiscal consolidation. Professionally, politically and socially the most difficult part of fiscal consolidation is the reform of the largest public enterprises and the resolution of status of unsuccessful enterprises in the process of privatization. Even though, at first glance, it may seem that certain problems have been solved in 2015, this is mostly the consequence of temporary circumstance and not of lasting resolution of these problems. For instance, this year Srbijagas is charging for gas it delivers to state-owned enterprises, which was not the case earlier. However, this is because the state has allocated certain budget funds in 2014 for these enterprises, to facilitate their preparations for privatization; and another favourable circumstance is that the market prices of raw materials (oil, gas, iron, ore) are currently very low. Hope that the problems of public and state-owned enterprises will be solved in the end (even with some delay) is stirred by the fact that this is one of the main pillars of the arrangement with the IMF and that, in addition to IMF, the World Bank and EBRD are also lending expert support in this process.

Due to its size and poor performance, EPS is the greatest individual fiscal risk at the moment. The state of finances in EPS has been deteriorating for years. Even though there have been no direct fiscal costs so far due to the company's poor business operations, the

increasing need for liquidity loans is more than alarming, and the possibility that the state may, in the future, take over the guaranteed, and perhaps even the unguaranteed debt of the EPS which, at this moment, amounts to 1 bn Euros cannot be excluded. In mid-2014, in its report on public and state-owned enterprises, the Fiscal Council pointed out the five largest issues of EPS: 1) non-economic electricity tariff; 2) excess employment; 3) poor claim collection; 4) significant losses through distribution network and theft; and 5) organisational weaknesses. The agreement with the IMF includes the development of a financial restructuring program for EPS, which will definitely deal with the aforementioned problems and which is the prerequisite for the approval of the first IMF arrangement review at the end of June. This program has been prepared and the Government adopted it at the beginning of June, but its details are still unavailable to the public. First announcements from this program, indicating that the electricity tariff could rise by 12% in August (of which only 4.5% would go to EPS) hint at the beginning of resolution of the company's accumulated problems (and, in our opinion, only the first phase in reaching the economic electricity tariff). In this report, the Fiscal Council has shown all the key problems of EPS in a little more detail, pointed out certain concrete measures that would, in our opinion, be necessary for their resolution, but also the risks related to the implementation of such measures.

Srbijagas will not be able to do its business successfully until the status of state-owned enterprises from the petrochemical complex has been resolved, but this must not be an excuse to postpone the solution of numerous other problems in the company's operation. In recent years, Srbijagas has been by far the largest loss-making company in Serbia and the main reason for their losses lies in the fact that they could not successfully charge for as much as 40% of the gas they delivered. State-owned enterprises in the petrochemical sector (Petrohemija, Azotara and MSK), as well as Železara Smederevo, owe the largest debt to Srbijagas. Since 2015, Srbijagas has begun to charge for the delivered gas temporarily, but in order for this problem to be finally overcome, the status of all the aforementioned companies will have to be resolved. It is encouraging that the Government has recently formed a Working Group for the resolution of the statuses of companies in the petrochemical complex, lead by the Minister of Economy. By solving the issue of petrochemical companies (and Železara), Srbijagas would take an enormous, but insufficient step towards a sustainable business model. Srbijagas's organization is not in line with the EU Directive, which prescribes a separation of companies providing transport and storage from companies working in gas distribution and procurement. In addition, there are numerous strategic issues still open with regards to this company's business operations, especially prominent after the abolition of the Southern Stream development: at which prices and in which manner is the gas procured, what is the return on investment into alternative gas sources and numerous other issues.

Serbian Railways have undertaken their first reform measures by adopting the plan of the company's status changes, but measures that are vital for the realization of necessary savings are yet to be undertaken. Despite large state aid granted to Serbian Railways (over 150 million Euros per year), the railway system is still in a bad state. By the adoption of a plan for the company's status changes, first organisational reform measures have been implemented. Instead of operating, as it had done thus far, as a single company, Railways will be divided into four companies (for passenger transport, freight, infrastructure and a holding company), which would harmonize this company with the common European practice. However, key measures for achieving lasting and necessary savings still lie ahead: rationalization of the number of employees by at least a third, rationalization of the railroad network and a reduction in the vehicle fleet. In addition, it has been announced that the subsidies for the freight company will be completely abolished from 2018 and being that

Railways are currently the largest recipient of state subsidies, this plan will only be executable through a consistent implementation of the aforementioned savings measures. Another serious problem for Railways is the high inefficiency in investment realization - the funds and projects are available, but the investments are not being implemented, resulting in further deterioration in the railroad network. We expect the new company handling infrastructural activities to resolve this inefficiency and improve the quality of the entire network.

As the deadline for the completion of privatization approaches, numerous (often justified) exceptions appear, but the state should keep them to a minimum. There are currently 526 enterprises with about 93,000 employees undergoing privatization. As a rule, these are unsuccessful businesses which have failed to be privatized in over ten years (or their privatizations were annulled), which survived exclusively thanks to direct and indirect (non-payment of taxes and contributions) state aid. Enterprises undergoing privatization are not just an expenditure in the budget, they disseminated their non-liquidity to both public enterprises and the private sector, as they frequently failed to pay for goods and services delivered. This is why the final solution of the status of these enterprises is not just a good fiscal measure, but also an economic one. On the other hand, there are indisputable social issues related to these enterprises, as it is imminent that a certain number of employees (whose jobs have been lost long ago) will be laid off, which will be very difficult. The Government has set aside 17 enterprises of strategic importance with 22,000 employees, for which the protection from creditors has been extended by another year; in addition, for certain companies with a little over 20,000 employees, a certain model has been found that prescribes a limited extension of the deadlines for the completion of privatization. Although the Fiscal Council believes that the state should have refrained from providing exceptions for individual enterprises and extending the deadlines for privatization - even if the current plan were to be realized, it would be a great success. This, however, is still not certain. There are different pressures at work and attempts to prolong the status quo (for example, by converting the public enterprises' claims into equity share, through which the companies undergoing privatization would become a part of public enterprises). An illustrative example of a widely held expectation that, in the end, a way will be found to extend the existing deadlines is the fact that only a minimal number of people employed in these companies have registered for social programs. If these enterprises were to undergo bankruptcy, it is highly unlikely that these employees would receive compensations that are anything like to those from the social programs.

At the beginning of 2015, there are still no reliable signs of the beginnings of a sustainable economic recovery. Economic activity in the first quarter has sustained a relatively deep year-on-year drop of 1.8%, which is approximately in line with the prognosis for a 0.5% drop in economic activity in 2015. By the end of the year, there are many parameters that could significantly affect the GDP growth rate in 2015. For example, the agricultural flows are still unknown and will depend on weather. The projections for a GDP drop of 0.5% take into account an average season in agriculture. However, in case of a highly successful season, it could increase the GDP growth by 1 pp (in which case the GDP growth in 2015 could even be positive), but if the season is poor, it would have the reverse effect on economic growth, i.e. the drop would be even larger than 0.5%. A sustainable recovery of Serbian economy can only be based on a strong, long term growth of net export and investment. Analysis of the results of net export and investments achieved at the beginning of 2015, however, offers no indications that such a lasting, sustainable recovery is starting. For this reason, even independent of GDP growth rate that will be achieved in the end, the Fiscal Council is still unable to give a favourable assessment of the economic activity trends indicated by the start of 2015.