HIGHLIGHTS

Highlight 1. Fiscal Consolidation 2012-14 Vs 2015-17: is this Time any Different?

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Introduction

At the end of 2014, a new three-year programme of fiscal consolidation started, which in addition to budgetary savings foresees also comprehensive structural reforms. Previous attempt (2012-14) to return national public finances to a sustainable path did not yield any results despite severe austerity measures, as all realised savings were "eaten up" by unreformed public sector. Primarily due to increased tax indiscipline and huge budgetary expenses for companies and banks owned by the state, measures taken in 2012-13 (such as real reduction of salaries in the public sector and pensions and increase of tax rates) were sacrificed in vain – in 2014 an equally high deficit was recorded as at the beginning of fiscal consolidation in 2012. Used up measures, however, were not the only cost of delaying structural reforms. The starting position now is actually much worse – state debt increased in the meantime from 58% to 73% of GDP and cost of interest on public debt has doubled and will continue to grow, so the upcoming fiscal adjustment will be all the more harder. Even though first positive results of the current programme are already reflected in the budget, we are once again faced with the same structural problems whose lack of solution had condemned the previous attempt at fiscal consolidation to failure. We therefore pose this question: will this time be any different?

1. Fiscal Consolidation 2012-14: Where Did We Go Wrong?

During 2012 it had become certain that public finances in Serbia would not be sustainable in the long-term without a substantial shift in conducting fiscal policy. Government's response to high deficit of 6.8% of GDP and growing public debt which had reached a level of 58% of GDP was an ambitious three-year programme of fiscal consolidation. The plan for reducing budget deficit rested on three pillars: 1) on the side of public expenditures, the key measure was a limited growth of salaries in the public sector and pensions; 2) on the side of public revenues, several tax rates were increased; and 3) planned within structural reforms were the reform of public enterprises, finalisation of the restructuring process, pension reform, strengthening of tax administration, etc. Although this set of budget saving measures was seemingly less drastic than the one implemented today – decrease of public sector salaries and pensions, the size of the planned fiscal adjustment is actually quite comparable. During 2013, the increase of public sector salaries and pensions was limited (instead of adjusting for inflation, a 2% indexation was performed in April and 0.5% in October), which with an average inflation of 7.7% was equivalent to their real reduction by around 5%.[2] Add to that expected effects of increased tax rates and it becomes clear that the set of measures for reducing deficit in 2012 was at least as ambitious as the one today, which in 2015 actually comes down to real reduction of salary and pension funds by around 8%, observed collectively.

However, instead of the announced strengthening of tax administration and tax discipline, quite the opposite happened in 2013 – a significant decline in collection efficiency and an increase of tax evasion. In the last quarter of 2012, general VAT rate was increased from 18% to 20%, which corresponds to the increase of effective rate by 8.5%. Considering this increase in VAT rate and real value of inflation and domestic demand (which presents a tax basis for VAT), we had expected in 2013 that these revenues would be collected in the amount of around 420 billion dinars. However, real revenue from VAT in that year was around 40 billion lower and was around 380 billion dinars and the main reason for this shortfall was the significant increase of tax indiscipline.[3] Graph 1 shows the efficiency of VAT collection in which two sharp declines can be observed: first during 2009 and second during 2013.[4] The decline in collection efficiency and transfer of the part of economic activity into the grey area at the time of the first strike of economic crisis was somewhat expected, but in 2013, lower collection of VAT was probably the result of numerous organisational weaknesses within the Tax Administration. Analysis shows that out of the total shortfall, as much as 35 billion dinars were due to the weaker tax

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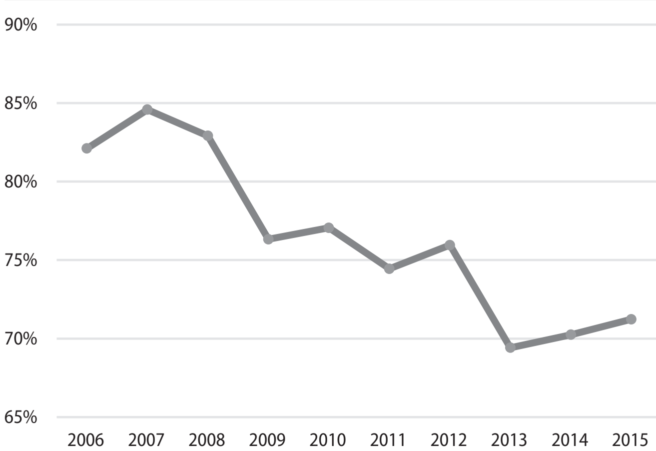
2 Having in mind that average inflation of around 11% had been foreseen in the planning stage, planned real reduction of these budget expenditures was even higher.

3 Shortfall of VAT revenue compared to that plan was even more pronounced due to objective reasons (real average inflation was lower than the one used for fiscal projections), but also due to optimistic budgeting.

4 VAT collection efficiency (the so-called C – efficiency) is calculated according to the following formula: Collection efficiency = Collected VAT revenue / (Domestic nominal spending * VAT rate).

collection. In other words, had the degree of collection been kept at a level from 2012, VAT revenues would have been higher by 1% of GDP.

Graph 1: VAT Collection Efficiency (C – efficiency)



Increase of tax rates would, therefore, undoubtedly lead to a growth of total state revenue had the work efficiency of the tax authorities at least remained at the (otherwise modest) level from 2012. Therefore, the assessments heard in the public that increase of tax rates is counter-productive, i.e. that instead of consolidating public finances they would lead to a decline of total revenue and consequently growth of deficit (a theoretical concept known as Laffer curve) are not valid. In addition, for the effect of Laffer curve to even show, tax rates would have to be extremely high, which even after their increase certainly wasn't the case in Serbia. On the contrary, with a VAT rate of 20% and corporate income tax of 15%, the tax burden in Serbia was still below the average of European countries.5 Current data on collected taxes provide an empirical confirmation that the assumption of the effects of the Laffer curve was wrong: with equally high tax rates, revenue from VAT and excise have been recording a mild growth ever since the second half of 2014. This is most probably a consequence of a slightly better tax collection, which is the result of applied measures for combating grey economy.

Also unfounded were claims that the increase of tax rates would have an extremely negative effect on GDP growth, which would contrary to intentions, lead to an increase of fiscal deficit (so-called *self-defeating* fiscal consolidation). It is indisputable that tax increases have a negative effect on economic growth and the size of that effect is usually expressed through tax multiplier. However, for a country like Serbia, the value of tax multiplier would have to be quite high in order for the applied increase of tax rates to significantly slow down economic growth and therefore increase the fiscal deficit in percentages of GDP (around 3 according to our calculation). That is, if tax multiplier would indeed be 3, increase of tax revenue by 1% of GDP would decrease the GDP growth rate by 3 percentage points. On the other hand, the reduced growth of GDP would have a direct impact on the decline of tax revenue by 1.05% of GDP (since their share in GDP in Serbia is around 0.35). In this hypothetical example, increase of tax rate would indeed lead to a mild increase of deficit by 0.05% of GDP. Even though there are still no precise assessments of tax multiplier for Serbia, study results for comparative countries indicate that it is probably below 1 – so three times less than what is needed for applied increase of tax rates to be counter-productive.

Negative fiscal trends in 2013, primarily on the side of public revenue, have prompted additional austerity measures with the aim of maintaining fiscal deficit within the limits of the initial plan. Solidarity tax was introduced on public sector salaries above 60,000 dinars, while the lower VAT rate was raised from 8% to 10%. However, already in 2013 a significant growth of state expenditures began due to neglecting and delaying the necessary structural reforms (cost of covering losses of state enterprises and failed banks), so even with additional austerity measures, only a slight reduction of deficit was recorded in 2013 to (still high) 5.5% of GDP.

Huge problems in the operation of numerous state-owned companies were recognised back in 2012 and solution of those problems was an important part of the initial plan of fiscal consolidation. In mid-2013, while conducting a budget rebalancing, the Government explicitly cited problematic companies that needed adequate solutions as soon as possible (Srbijagas, Železara Smederevo, Galenika, Resavica, Dunav osiguranje, and others), but no concrete steps were taken. For example, production in Železara Smederevo (Steelworks) had started again at the beginning of 2013 with the help of a guaranteed loan with the aim of knowing the final status of Železara at the beginning of 2014. However, even after that deadline had expired, the state continued to finance the production of this company which, according to some estimates, cost the state budget 5-10 billion euros (in this regard, in December 2014 Development Fund approved funds for Železara in the amount of over 100 million euros, which is *de facto* a state intervention).

What is especially problematic is constant extension of deadline for finalising the process of restructuring state enterprises, which was supposed to be over in the first half of 2014. Even though direct budget expenditures

5 In 2013, average VAT rate in Europe was slightly higher than in Serbia and was around 21%, while the average corporate income tax rate was almost 20%. By comparison, some countries in the region had even higher VAT rates than Serbia, such as Hungary (27%) and Romania (24%).

for this group of companies are not extremely high (the biggest budget subsidy is intended for Resavica in the amount of 4 billion dinars a year), by tolerating their non-payment of taxes, contributions and obligations towards suppliers, the state is indirectly subsidising them quite generously. Not to mention the accumulated debts for consumed gas and supplied electricity of large state systems which have seriously jeopardised operations of public companies, which has already partially spilled over to the state budget. The most obvious example is Srbijagas which has recorded huge losses in the previous years due to, among other reasons, inability to collect receivables from state enterprises such as Azotara, Petrohemija, Železara Smederevo, MSK, and others. Due to chronic illiquidity, Srbijagas is not able to independently pay off loans for which the state provided guarantees in the previous period. So, activated guarantees of this company in 2014 cost the state budget around 150 million euros, and that wasn't even the entire amount of state aid: Srbijagas was approved direct budget loan of around 9 billion dinars, as well as a new guarantee for a 200 million dollar loan. This means that the state in 2014 directly or indirectly aided this public company in the amount that is approximately equal to total savings that will be realised in 2015 from the reduction of pensions and salaries in the public sector (almost 400 million euros).

EPS obligations still have not been a direct cost of the state, but is important to mention that one of the sources of losses and problems with liquidity of this company are huge debts of companies undergoing restructuring for supplied electricity (in addition to internal issues such as low price of electricity, overstaffing, technical losses in the grid, and others). The debts of seventeen strategically important companies undergoing restructuring alone, for which the Government has extended protection from creditors for another year, amount to 20 billion dinars. In case a strategic partner is found or privatisation of this company conducted, the debts towards EPS will most probably be written off, which will additionally deteriorate the financial bottom line of this company.

Lack of preventive measures in the banking and insurance sector, mainly in the part that is state owned, also led to new budgetary expenditures. Liquidation of Privredna Banka Beograd (Commercial Bank Belgrade) and Univerzal Bank (Universal Bank) have increased the state expenditures since the end of 2013 by almost 200 million euros, including the recapitalisation of Poštanska štedionica (Postal Savings Bank) of around 5 billion dinars, which assumed part of the obligations of these bankrupt banks. An illustrative example of poor management by the state is insurance company "Dunav osiguranje". By increasing the number of employees in the period 2007-2012 by around 50% with objectively unchanged scope of work, Dunav which was a relatively profitable company started to record losses. However, even though key issues in business operations were identified, concrete measures were not taken, so in 2014 it was necessary to recapitalise this company from budget funds in the amount of around 5 billion dinars.

Delay of necessary reforms in the sector of state enterprises and banks has completely nullified all previous efforts to heal domestic public finances. In 2014, general deficit of 6.7% of GDP was recorded, equally high as at the beginning of fiscal consolidation in 2012 (6.8%), making the severe measures of budget savings in terms of real reduction of salaries and pensions and increase of tax rates vain sacrifices. Fiscal deficit in 2014 could have been even higher (around 7.7%) and thus show in even more realistic terms the true price of unreformed state sector, had it not been in that year for unplanned large "savings" on capital expenditures (public investments were conducted in the amount of around 300 million euros lower than planned, which made "savings" of 1% of GDP). Starting position before that beginning of the Government's new three-year programme (2015-17) for reducing deficit is only seemingly similar to the previous attempt – public debt has increased in the meantime from 58% of GDP to over 73% of GDP, and budget expenses for interest in 2015 will be twice as high compared to 2012. That fiscal consolidation is much more difficult when the level of indebtedness is higher is confirmed by the fact that cost of interest in the coming years will increase on average by around 20 billion dinars a year, despite the planned reduction of deficit. This means that each following year will require savings of around 0.5% of GDP just to maintain the deficit at the level from previous years (which is almost comparable to the reduction of pensions fund by around 5% which will yield savings in 2015 of around 0.6% of GDP).

In less than three years, Serbia went from averagely indebted country to one of the most indebted countries in the region, and by cost of interest on public debt which will reach 3.5% of GDP this year or over 1.1 billion euros, it is at the very top in Europe. Just how expensive Serbia's public debt is is best demonstrated by comparing it to Greece, debt of which is around 180% of GDP, but it allocates only 0.7 p.p. of GDP more of budget funds to interest (in addition, it is expected that along with the planned severe reduction of deficit, cost of interest in Serbia by 2017 will reach almost 4% of GDP, which would make the gap between us and Greece practically disappear). Defeating fact is also that we are already spending more on interests than on public investments and only slightly less than total expenditures on education and science (which along with all other accompanying expenses is enough to pay salaries for over 150,000 employees in this sector).

Having all this in mind, it is quite an irony that one of the important reasons for delaying necessary structural reforms was lack of pressure from international financial markets and relatively cheap borrowing for Serbia in 2013, albeit in dollars. Not only did the state relatively easily finance the current obligations by new borrowing, but the replacement of more expensive loans by cheaper ones was supposed to be an important lever for reducing cost of interests and fiscal deficit, but it did not happen. On the contrary, strengthening of dollar since mid-2014 has increased the cost of all existing dollar obligations and the level of public debt expressed in euros has increased by more than 1 billion euros. This is yet another proof that there are no easy or painless solutions for resolving essential and structural problems of public finances.

2. Such a Severe Fiscal Consolidation Is Possible: The Case of Romania

Unsuccessful first attempt at consolidating public finances is not a rare occurrence, but there are several countries which managed through responsible and consistent implementation of severe austerity measures and structural reforms to significantly reduce the deficit and thus halt the growth of public debt in a three year period. Romania can serve as an illustrative example as a country that is not only in our region, but whose size and structure of implemented fiscal consolidation is comparable to the challenge Serbia is currently facing. Arrival of the global crisis and deep recession in 2009, as well as deteriorated external conditions of borrowing, brought Romania to the verge of bankruptcy – in order to finance the deficit and matured debt it was necessary to secure almost 20% of GDP.[6] Severe austerity measures started in mid-2010 and the biggest burden of fiscal adjustment was borne by public sector employees. Salaries were cut by 25% and the number of public sector employees was reduced by around 200,000 within three years (mostly in local self-governments, education, healthcare and police), i.e. by around 15%. Even though a reduction of social expenditures was initially planned, nominal reduction of pensions by 15% was abandoned after the Constitutional Court intervened. However, in order to make up for the lost savings on pensions, Romanian Government was forced to increase the VAT rate by astounding 5 percentage points all at once, from 19% to 24%. It is important to stress that these draconian measures of budget savings were relatively successfully accompanied by a set of structural reforms whose aim was to improve the business environment and increase public sector efficiency. The end result was impressive – in only three years, the fiscal deficit was reduced from around 9% of GDP to 3% of GDP in 2012, public debt stabilised at the level of around 40% of GDP and Romanian economy is now already achieving remarkable growth rates in the European context.

Analysis of Romanian experience with fiscal consolidation can offer several answers to the question why our first programme of reducing fiscal deficit was unsuccessful and also offer a road map for the current programme. First of all, crucial for the success is the consistent implementation of sufficiently severe austerity measures, but with timely addressing the structural issues which have led to the creation of huge budget deficit in the first place. Probably equally important is the Government's dedication to the fulfilment of the programme: Romania did not have much choice – strong measures were picked as there was no fiscal room for further hesitation and the IMF arrangement had additionally anchored the set goals of fiscal adjustment. There was no similar pressure in the case of Serbia in 2012-2014. Favourable international conditions and consequent easy borrowing during 2013-14 created an illusion that the state of Serbian public finances is not alarmingly bad and that less painful measures were enough to solve the problem, with the support of IMF. By the way, Serbia had two unsuccessful negotiations with IMF about the new arrangement and looking back it seems they were conducted exclusively out of a desire to calm the foreign creditors, but without any real desire to reach an agreement. Perhaps the most important message of the successful consolidation in Romania for us today is that any leeway in implementing fiscal consolidation is not acceptable before the set goals are actually achieved. Romania partially compensated for the initial reduction of public sector salaries only after three years and only because it became certain that despite this salary increase the deficit would still be the planned 3% of GDP. On the other hand, effective reduction of VAT rate, after the drastic increase of tax rate at the beginning of the programme, was done much later, i.e. at the beginning of 2015. Recovery of economic activity and fiscal deficit of below 2% of GDP have enabled the Romanian Government to transfer food products and non-alcoholic beverages from the general rate, which is still 24%, to the lower VAT rate of 9% and thus additionally stimulate private consumption and economic growth without jeopardising fiscal sustainability.

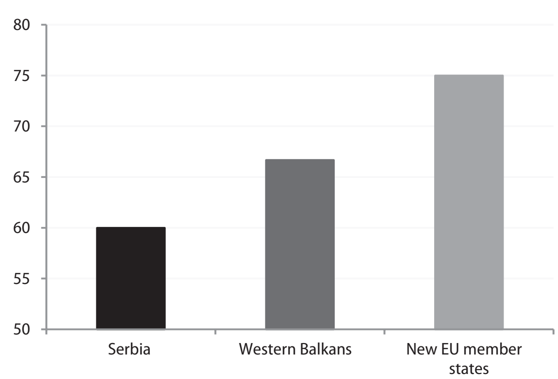
6 By comparison, in order to finance the deficit and matured principles of existing debts, Serbia has to borrow around 5.5 billion euros a year, which is a disconcertingly high 17% of GDP.

3. Fiscal Consolidation 2015-17: Where Are We Currently?

New three-year programme of fiscal consolidation started at the end of 2014 and, considering the planned reduction of budget deficit, it is equally ambitious as the previous one from 2012. First results are already reflected in the budget: shortage in the first four months of 2015 was only 22 billion dinars, while in the same period last year, the state deficit was four times higher. Recorded deficit seems to be significantly better compared to the plan due to once-off and out of the ordinary increase of non-tax revenue (primarily unusually high revenue from dividends and profit deposits by public companies and agencies for this period of the year), but also due to a noticeable delay in the execution of public investments. It would seem that part of the reduced deficit is of permanent (structural) nature and is the result of reduction of salaries and pensions at the end of 2014, which is yielding expected and planned savings, as well as mild improvement in the collection of tax revenues.[7] The biggest challenges, however, are still ahead.

The Government is once again faced with the same wall of structural reforms which was an insurmountable obstacle in the past and the main cause of failure of the first attempt at fiscal consolidation. No matter how difficult and painful the reduction of public sector salaries and pensions was, experiences so far indicate that the main obstacle in achieving set goals was actually unreformed and semi-market economy. According to EBRD data, in Serbia in 2010 still around 40% of total GDP was realised in the public sector, which is considerably higher than in comparable countries (Graph 2). That the situation has not significantly changed in the last five years is confirmed by the fact that even now almost 45% of the formally employed are working in the public sector: state and local administration, education, healthcare, public and state enterprises.

Graph 2: Share of Private Sector in Realised GDP in 2010



Source: EBRD

7 See monthly report of the Fiscal Council: Fiscal Trends in March 2015.

There are certain reasons why end result of fiscal consolidation now could be different. Part of necessary structural reforms was already concluded in 2014 – with a delay of over a year, pension system reform was finally adopted and Labour Law was harmonised with European standards. Even though pension reform does not yield substantial fiscal savings in the short term, it is of key importance for long term sustainability of national pension system, while changes to the Labour Law present an important improvement of business environment. In addition, fiscal consolidation measures implemented so far are being consistently implemented (reduction of salaries and pensions at the end of 2014) and this is producing planned budgetary savings. However, probably the most important reason is the signing of the three-year IMF arrangement, which is of crucial importance for the credibility of the programme and creditors' trust – without the arrangement, foreign creditors would rate significantly lower the programme that foresees growth of public debt for another three to four years. Agreement with IMF includes pretty detailed plans and deadlines for implementing all foreseen measures (as well as quarterly progress reports by this financial institution), which enables the wider public to easily follow the realisation of goals to which the Government has committed. Additional advantage is expert assistance that can be offered by IMF, World Bank, EBRD and other international institutions included in this programme in solving professionally difficult issues in public and state companies.

On the other hand, plans for the most problematic public enterprises such as EPS, Železnica and Srbijagas are being prepared, so it is still unknown what will be the Government's approach to resolving their core issues (overstaffing, low prices, poor collection, technological obsolescence, and other). Still, even after the plans have been made (plan for financial restructuring of EPS is expected in June), there is still the implementation of these reform measures which is also the most difficult part. Similar applies to rationalisation of public sector employment, which should provide significant budget savings in this and the following two years from the reduction in the number of employees by around 5% a year. What is good is that detailed analyses of the existing state are done, but there is still no concrete plan of layoffs, as well as a plan for the reform/rationalisation of key sectors: healthcare, education, police, judiciary, etc.

Avoiding the solving of the status of companies in restructuring, as we have seen, was one of the main causes of failure of the fiscal consolidation programme 2012-14. However, even though protection from creditors for these companies was due to expire in May 2015 (which would mean for most companies insolvency and bankruptcy), the Government extended this deadline for the group of 17 strategically most important and biggest enterprises for another year. The delay is to a certain extent understandable since it was not realistic to expect privatisation or finding strategic partners for all companies in just a few months – but only if the new deadlines are fully respected (although it is perfectly valid to raise a question of why so little had been done in the previous period). It is important to note that this delay could potentially lead to new budgetary spending. If the state, with the aim of finding strategic partners, took on commercial debts of these companies (which has already been done in the case of JAT in the amount of around 20 billion dinars in 2014), additional spending could in worst case scenario reach as much as 700 million euros, which would be absolutely unsustainable.[8] In addition, it remains to be seen how this would affect operations of Srbijagas, i.e. whether the companies that are not restructured: Petrohemija and Azotara would still spill over their losses to Srbijagas and thus indirectly to the state budget.

Announcements of the officials about possible increase of public sector salaries and pensions already in 2015 jeopardise (if implemented) the credibility of the entire programme. Abandoning the main measure of fiscal consolidation, which is by far the biggest source of permanent (structural) budgetary savings, even in part, would certainly lead to the new growth of fiscal deficit. Such statements are premature and are the result of exaggerated optimism based on currently better fiscal trends compared to the plan (which is probably only temporary) and expectations of a stronger economic growth which is still not visible through official statistical data (and is therefore unreliable). Creating a false image that crisis is practically behind us is very dangerous and could seriously diminish the public's readiness for reforms before they have even started. Any leeway before the main cause of unsustainable state in national public finances is completely removed, and according to our previous experience with fiscal consolidation it is the unreformed public sector, could lead to austerity measures taken so far becoming yet another vain sacrifice.

Whether this time will actually be different basically depends on the success of reforms of three key public sectors: public enterprises, enterprises in restructuring, and public administration. Three-year arrangement with IMF gives credibility to the programme of fiscal consolidation, but it also requires the arranged agreements to be implemented. Even Government officials stress in their public appearances the commitment to the set reform course and the respect of signed agreement with this international institution. On the other hand, plans for the reform of state-owned enterprises and public administration are only in preparation phase (some deadlines are even being postponed), so the implementation of measures, which is the biggest challenge, has not yet started. Having in mind that fiscal consolidation 2012-14 failed precisely because attentions and plans to reform the public sector were abandoned when it came to implementing them, the success of current programme is still uncertain. On the contrary, we can say we are only at the beginning of a three-year period (at best) during which it will be necessary to implement difficult and painful reforms. Therefore, this first, and mostly temporary, reduction of fiscal deficit cannot serve as an excuse to relax (increase of salaries and pensions already at the end of this year?) before the main cause of unsustainable national public finances is removed, and that is the unreformed public sector.

8 According to the last available data, in 2013 commercial debts of 17 strategically important enterprises in restructuring amounted to around 700 million euros.