Context

- Fiscal imbalances have been piling up since 2008/9
- Attempts to stop the growing public debt proved ineffective: e.g., 2009 and 2011 SBA, and stopgap measures in 2013/14
- 3-year IMF precautionary SBA approved in February 2015, with three main objectives:
  - Address macroeconomic imbalances and vulnerabilities, most notably by placing public debt on a sustainable path
  - Bolster resilience of the financial sector and improve its intermediation function necessary to support growth
  - Improve competitiveness and reduce key growth bottlenecks through vigorous implementation of comprehensive structural and SOE reforms
What do we learn from Serbia’s fiscal reforms?

- Focusing fiscal issues in Serbia, the presentation offers a real example to illustrate:
  - What caused the growing fiscal imbalances
  - How policy was designed to address the root causes of the imbalances
  - How the policy has been implemented
  - And what kind of risks and challenges the policy implementation faces
Outline

• Part 1. Fiscal Developments Since 2008/9
• Part 2. Causes of Fiscal Imbalances
• Part 3. Fiscal Program Objectives And Policy Design
• Part 4. Progress So Far And Challenges Ahead
Part 1. Fiscal Developments Since 2008/9
High deficit and growing debt

- GG deficit increased from 2½ percent of GDP in 2008 to over 7 percent in 2012, and remained high until 2014.
- Public sector debt grew from 32½ percent of GDP in 2008 to 72½ percent in 2014.
Weak revenue

- Weak and fragile post-crisis recovery—3 recessions in the last 6 years
- Revenue has declined from 42½ percent of GDP in 2007 to 38 percent in 2013 until some recovery in 2014.
High entitlement spending

- Expenditure has increased despite consolidation efforts in 2011 and 13.
- Entitlement spending—GG wage bills, pension, and subsidies—has grown from 24 percent of GDP in 2007 to 27\(\frac{1}{4}\) percent in 2014.
Decomposition of debt growth

- Growing guarantees and materialization of contingent liabilities (i.e., amortization of called guarantees + bank bailout cost) account for 20 percent of debt increase in the last 4 years.
- Exchange rate depreciation also increased debt burden significantly.
Part 2. Causes of Fiscal Imbalances
Stagnant growth and weak labor market performance

- 3 recessions in the last 6 years
- Unemployment remains very high, while employment has been declining
- Total population is 7.2 million, but formal employment is 1.7 million, equal to the number of pensioners
Weak revenue collection

- Share of indirect tax—VAT and Excise—is relatively high (about 45 percent of tax revenues), reflecting the labor market situation
- Growing grey economy and declining tax efficiency until 2014
- VAT efficiency weakening: Effect of the rate hike in September 2012 (18 to 20%) was limited
Weak control over GG wage bill

- High GG wage bill
  - High inefficiency in some sectors
  - High wage rate compared to the private sector
- Weak control and high wage drift until 2013
  - Number of workers
  - Overly complex and fragmented wage system

### Average monthly gross wage (RSD)

<table>
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<tr>
<th>Year</th>
<th>Public sector</th>
<th>Private sector</th>
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<tr>
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<td>2014</td>
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### Public Sector Wage System

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<tr>
<td>Laws that regulate renumeration</td>
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</tr>
</tbody>
</table>
Pension dilemma—neither considered enough nor affordable

- Unfavorable population age profile
- Social expectations:
  - High replacement ratio: 70 percent, but about €200 per month on average
  - Generous early retirement: statutory vs. effective retirement age (Man: 63 vs. 60) before the reform
- Internationally high pension spending
- Growing share of the population stays outside the system—risk to future social protection spending
Inefficient state aid and drain on the budget

- Lack of transparency and weak governance
- State aid for employment
  - Railways: budget subsidies = total wage bill
  - Large loss-making companies—direct or indirect support
- Weak financial control and payment discipline
  - State guarantees for liquidity loans with little prospect for repayment
  - Arrears to utility companies
- Bank bailout cost
Symptoms and root causes

- **Symptoms**
  - Weak revenue, high spending, growing debt
- **Permanent fix needs to address root causes, not symptoms**
- **Root causes**
  - Weak growth
  - Poor labor market performance and employment structure
  - Weak tax administration and public financial management
  - High public sector wage bills and pension bills
  - Lack of reforms in public companies
  - Frequent materialization of contingent liabilities
Part 3. Fiscal Program Objectives and Policy Design
Fiscal objectives

- Reverse the rise in public debt by 2017 and put it on a downward path thereafter (chart)
- 3-year fiscal adjustment, amounting to $4\frac{3}{4}$ percent of GDP ($3\frac{1}{2}$ percent of GDP in structural terms)
  - Productive spending should be protected
  - The savings from the consolidation measures should be lasting
- Strike balance between credibility and growth impact
  - Slightly over 50 percent of the adjustment takes place in 2015
Policy measures: before program

- Key structural reforms and consolidation measure in the summer 2014
  - Labor law amendments
    - Raise the threshold for automatic extension of collective agreement
    - Clarify the cases for dismissal
    - Rationalize severance compensation
    - Extend the maximum length of temporary contracts
  - Parametric pension reforms
    - Gradually raise the statutory retirement age for women
    - Introduce early retirement penalty
  - 10 percent wage cut and 22/25 percent pension cut
Program measures

- Limited room for tax rate hikes
- Focus on containing entitlement spending (2/3) and state aid (1/3)
  - In addition to wage and pension cuts
  - Wage and pension indexation freeze—until their GDP shares reach 7 and 11 percent of GDP, respectively
  - Reduction of employment cost by 5 percent each in 2015-17 (rightsizing via attrition and targeted separation)
  - Reduction of state aid to public companies, underpinned by SOE reforms
  - No guarantee for liquidity loans
Structural fiscal reforms

- Structural reforms needed to support the fiscal consolidation and/or mitigate fiscal risks
  - Rightsizing to increase the efficiency of the general government, while reducing the cost, via its organizational and functional restructuring
  - Wage system reform to bring the wage system under control
  - Reforms to improve fiscal transparency, which is the first step for better accountability; better monitoring and control of fiscal risks
    - Introduction of 3-year expenditure ceiling
    - Clarification of the coverage of the general government
    - Improvement of the reliability and coverage of public sector employment registry
    - Strengthening of SOE financial monitoring function of MOF
    - Enhancement of the payment discipline between public sector entities
  - Tax administration reform to improve collection without rate hike
SOE reforms

- Subsidies to large SOEs have been a drain to the budget, and fiscal risks from them are significant
- SOE reforms, via privatization and/or restructuring, agreed to improve the financial viability of large SOEs and thus contain fiscal risks from them
  - Railways—unbundling and financial restructuring
  - Electricity Producer (EPS) —recorporatization and financial restructuring, including electricity price increases
  - Srbijagas—financial restructuring
  - Large steel and chemical companies—seeking privatization, assurance of no state aid and no accumulation of arrears
Growth enhancing measures

To mitigate the short-term impact of the fiscal retrenchment, and establish foundation for sustained growth:

- Reforms to promote investment
  - Construction permit and land development law
  - Land ownership conversion law
  - Investment law
  - WB-supported privatization
  - EBRD Investment Climate and Governance Initiatives
- Rebalancing policy mix toward monetary easing
- NPL resolutions to support credit growth
Part 4. Progress So Far and Challenges Ahead
First Review

- The First Review was completed on June 26
  - Performance Criteria met with good margins
  - Structural benchmarks were met with some delays
- Sovereign Credit Default Swap is falling
- Exchange rate stabilized
Challenges ahead

• Structural reforms
  ➢ Will reforms stick?
  ➢ Or will this effort be another band aid?

• Sustained consolidation is key for 2016-17
  ➢ Wage and pension indexation freeze until their GDP shares reach 7 and 11 percent, respectively
  ➢ General government rightsizing

• Return of sustainable high growth and improved tax collection will be strong tail wind for debt reduction