

EXECUTIVE SUMMARY

With its economy disrupted by the global economic crisis, the Serbian government faces tight budget constraints for several years to come. The Government has already responded by freezing wages and pension benefits and making cuts in capital works and other discretionary spending. These measures, while effective in the short term, are not necessarily sustainable over time. This report looks at more fundamental reforms in key public services, in order to identify opportunities for constraining expenditures through improvements in productivity.

Pensions. Pensions are the largest single program of government expenditure. Costs are high, due in part to generous benefits. The pension due to a new retiree in Serbia is equal to nearly 60 percent of the net average wage. Due to a variety of mechanisms that encourage early retirement, average retirement ages are lower than in most Organization for Economic Cooperation and Development (OECD) countries, and years of contribution, shorter. Pension costs are also driven up by demographics. Due to its low birth rate, Serbia has a large number of beneficiaries relative to the number of contributing workers.

As a short term response to the fiscal crisis, the Government has decided to freeze pension levels in nominal terms in 2009 and 2010. This is a highly desirable measure from a pension policy standpoint, as it will reduce the replacement level of pension benefits over the next two years. The Government should resist pressures to compensate for this reduction once the fiscal crisis ends. The Government should also consider other methods of reducing benefits on a permanent basis: limiting the number of years a worker can retire early, reducing pensions for early retirees (regardless of their years of contribution) and raising the retirement age for women. Savings can also be achieved by improving the administration of contributions and benefits.

In the longer term, the existing system of pension indexation will substantially reduce the financial burden of the pension system. Under current legislation, which will go back into effect once the fiscal emergency passes, pensions are to be indexed solely to inflation. Once growth resumes and wages rise in real terms, pension receipts will outstrip pension payments, resulting in a surplus-generating system, although one that pays very low benefits relative to average wages. Nevertheless, the Government would be wise to continue to index pensions solely to inflation until the replacement level falls to more affordable levels.

Health. Despite an array of management improvements to date, the Serbian health care system still suffers from a wide range of inefficiencies. The hospital bed occupancy rate is below the level of new European Union (EU) members and considerably below the level of older EU member states. While marginal efficiency gains can be achieved by administrative fiat, the key to fundamental improvements in health care productivity is a

change in the way it is financed. The present input-based system of financing encourages inefficiency in the use of resources and provides no incentive for improved service volumes or quality.

The Government is now in the process of reforming the health financing system. For primary care, it will adopt a capitation based payment system, in which primary physicians are paid according to the number of patients on their rosters. For higher level (hospital) care, the Ministry of Health and the Health Insurance Fund (HIF) intend to move to an output-based (Diagnostic-related Group (DRG) or prospective hospital payment) system. International experience shows that such reforms can generate substantial savings but need to be carefully designed to prevent fraud. The Government should continue the pilot testing of these reforms and move to full implementation as quickly as possible.

Education. The level of government spending on education in Serbia is comparable to other European countries (as a percent of GDP) but its outcomes are considerably poorer. There is evidence that significant savings could be achieved through the rationalization of the school network, particularly at the primary level, without reducing education quality. Serbia has too many teachers, given its present student population. As a result, many classes are inefficiently small.

Consolidating under-enrolled classes by shifting students to other classes in the same school (and grade) could reduce costs by ten percent. Consolidating under-enrolled classes by shifting students to other schools within the same municipality could reduce cost another 25 percent. The latter, however, would require some schools to be closed. This is a politically difficult step. Other countries in the region have found it useful to enlist local governments in this effort. The Bulgarian government, for example, allocates funding for education to each local government on the basis of enrollment, and allows each local government to recommend which schools and classes to close. Serbia should consider doing the same.

Social assistance. Serbia spends relatively little on social assistance. Of the little that is spent, less than one quarter is specifically targeted to poor households. The two poverty targeted programs—the MOP and the child allowance—are nevertheless well designed although under-funded. As the recession is likely to increase the number of needy households, the Government should consider increasing funding for these two programs.

Agricultural and enterprise subsidies. The Government spends a significant amount on agricultural subsidies, largely in the form of a fixed payment per hectare. While this is less distortionary than the input- and price subsidies it replaced, it is not particularly effective either in promoting agriculture or in reducing rural poverty. The area-based payment should be scaled back and means tested.

The system of subsidies to manufacturing and mining enterprises is in transition. In the past, subsidies have been used to facilitate privatization, financing severance

payments for workers in state- and socially-owned enterprises. As privatization has proceeded, the cost of these subsidies has declined and will continue to do so. (The Government's proposed equity investment in Zastava/FIAT remains an exception.) In the future, the Government will have to guard against a resumption of enterprise subsidies in the form of tax breaks and subsidized or unrecovered loans to private investors.

Roads. Serbia has a history of under-funding maintenance, which has led to the deterioration of much of the regional road network. The Government's current priority, nevertheless, is to upgrade segments of Corridor X (which, despite its foreign financing, still implies a considerable Government counterpart contribution). In the short term, spending on Corridor X is likely to be somewhat lower than originally planned, due to the time required to complete land acquisition and other preconstruction activities. The prospects for financing additional maintenance expenditures by increasing fuel taxes or tolls are limited, although better toll administration could have some impact. Resources for maintenance will instead have to come from efficiency gains, including improvements in the prioritization of maintenance projects and wider use of performance contracts.

Railroads. While freight traffic on the state railroad Zeleznice Srbije (ZS) has been growing, passenger traffic has been declining, and the financial performance of the company has continued to deteriorate. Current subsidies to the state railway company are insufficient to cover its operating losses. The Government nevertheless intends to invest over RSD144 billion in upgrading rail service in Corridor X. Immediate savings could be achieved by postponing the start of works in Corridor X and by reducing the design speed of the proposed works from 160 km/hr to 120 km/hr. The latter step would reduce the overall cost of the project by 60 percent. The company's recurrent operating losses could be reduced by abandoning under-used track, terminating underused passenger services, reducing staff, and raising passenger tariffs.

Summing up. Overall, the immediate annual savings yielded by these proposals could be equivalent to about eight percent of consolidated central government expenditures (in 2008). The proposed increase in the MOP and child benefits, along with the start of debt service on the road company's arrears, would reduce that figure to 6.7 percent. But this package assumes a fairly radical pace of reforms, including the immediate consolidation of under-enrolled classrooms within schools and among schools and an immediate 50 percent cut in area-based payments to farmers. Social pressures and administrative constraints may slow the pace of reform.

In 2010, the principal expenditure savings will instead continue to come from short term controls over expenditure aggregates: the freeze on pensions and wages and cuts in discretionary spending and capital works. The impact of the efficiency measures proposed in this report will take more time to materialize. The Government should, nevertheless, make an immediate start. While the fiscal impact of these reforms will be evident over the medium term, their most important impact will be on the quality of public services. The reforms will stand Serbia in good stead even after economic growth resumes.