



Republic of Serbia

**COVID-19 Pandemic:**

Economic Impact on Serbia and Options for Policy Response

April 9, 2020

## Introduction

**The escalating COVID-19 pandemic is having a significant impact on the Serbian economy.** In the first half of March, 168 companies were temporarily closed and nearly 5 percent of all employees were required to stay at home. Impact on services sectors – transport and tourism – is even more pronounced. Anecdotal evidence suggests that the transport sector has already suffered losses of about 110 million euros since the start of the crisis, while tourism has seen a large drop in arrivals and bookings for the first half of the year. Data on financial inflows – FDI and remittances, in particular – are not yet available but it is expected that those will be significantly lower than last year.

**The Bank projects a contraction of economic activity of around 2.5 percent in 2020.** The assumption underlying this projection is that much of the economic impact will be felt in the second quarter of the year, while a gradual economic recovery will start in the third quarter. The impact on the economy will vary across sectors. Manufacturing will be the worst affected with a projected decline in value added of around 9 percent. Services will also be badly affected, but to a varying degree. Sectors like transport and tourism will be affected the most given limited options to compensate losses in the first half of the year by overperformance in the second half. Total value added in services sectors is projected to decrease by about 1 percent in 2020 while agriculture sector is expected to grow slightly in 2020.

**The Serbian Government and the National Bank of Serbia (NBS) introduced some early measures to support living standards and the economy, while a large package of support measures was announced on March 31.** At the onset of the crisis, the government approved a one-off payment to pensioners (about 35 euros per person) in April and will increase salaries for health sector employees by 10 percent from April onwards. At the same time the NBS started providing additional liquidity to the system: it cut its policy rate from 2.25 to 1.75 percent and provided about EUR 400 million (0.9% of GDP) through FX swap and repo operations to the banking sector. A moratorium on debt repayments for 90 days to all clients was introduced by the NBS. In addition, the Serbia Tax Administration introduced a moratorium on tax payments for financially stressed entities.

**A new package of assistance to the economy and citizens worth around EUR 5 billion (11 percent of GDP) was announced on March 31<sup>st</sup>.** To mitigate the negative impact of the pandemic, the government approved a program to support SMEs and entrepreneurs through tax deferrals and compensation for wages to be paid to employees; support to larger enterprises includes subsidized lending through the Development Fund and issuance of guarantees. Finally, the program includes a one-off payment of EUR 100 to all adults. The table below summarizes announced measures and its estimated fiscal impact. The final package will be formally adopted by mid-April.

Table 1: Summary of the government's assistance program

Measures	billion Dinars	as %GDP
<b>Tax Policy</b>	<b>161.0</b>	<b>2.9</b>
PIT and social security deferrals delayed to 2021	140.0	2.5
Deferral of advance payment of CIT for Q2	21.0	0.4
Elimination of VAT for donations	na	na
<b>Support to the private sector</b>	<b>97.3</b>	<b>1.8</b>
Cover for 3-month wages in micro and SMEs	92.8	1.7
Support to large enterprises: 50% of the minimum wage to all employees whose contract ended	4.5	0.1
<b>Liquidity support for enterprises</b>	<b>264.0</b>	<b>4.8</b>
Support through the Development Fund	24.0	0.4
Guarantees scheme for loans provided by banks	240.0	4.4
<b>Other</b>	<b>86.0</b>	<b>1.6</b>
Moratorium on payment of dividends and loss of tax on dividends	16.0	0.3
Support for domestic demand (100 euros per adult)	70.0	1.3
<b>Total fiscal impact</b>	<b>368.3</b>	<b>6.7</b>
Issued guarantees	240.0	4.4
<b>Value of the package</b>	<b>608.3</b>	<b>11.0</b>

*Note: companies that reduced their employment by more than 10 percent since March 1 are not eligible for assistance.*

*Source: Ministry of Finance*

The remainder of the note offers ideas and suggestions how to operationalize the announced package with efficiency and impact, and what more Serbia could do in order to minimize the social and economic impact of the current pandemic. Information based in this text is as of April 8<sup>th</sup>, 2020.

## Operationalization of the Announced Package

To gain the full benefit from the announced package the government should stick to some general principles. In addition, based on previous and ongoing engagement and on global lessons, the Bank suggests some more detailed suggestions for consideration in planning the implementation of the support package.

## Main Principles in Implementation

Some of the general principles that should be followed relate to the public policy process and others relate to sound public financial management. The Bank recommends the following principles to be taken into consideration:

- **Timeliness:** the announced program needs to start as soon as possible in order to minimize the impact of the ongoing crisis.
- **Efficiency:** administrative procedures and costs should be minimized by relying whenever possible on existing institutions and rules and if possible, by lowering the number of required administrative steps.
- **Transparency:** to ensure continued widespread support and understanding of the effort, ensure transparency throughout the process.
- **Time-bound:** set a clear cut off date through which the impact is measured and for which the support is provided; if needed, the program can be extended.
- **Ensure targeting:** The program needs to be targeted toward those that are most affected– to minimize fiscal implications but also to maximize impact. However, given that time is of the essence, verification can happen ex post.
- **Triage and deploy investments:** government should triage and prioritize public investment projects – e.g., where can funding still be allocated and work continue, where should the activities be stopped in a way that minimizes damage and future costs; and activate the newly adopted PIM framework.
- **Cash management:** minimize the risk of arrears or disruptions in delivery of services by continuing uninterrupted payment of due commitments.
- **Expand Access:** Expand accessibility of key administrative functions online and by phone
- **Safeguard Securities:** Keep close communication with government securities market participants and adopt needed measures to meet the increasing funding need as well as to support the functioning of the secondary market.
- **Manage Fiscal Risk:** Expand fiscal risk monitoring and ensure that key decision makers are regularly informed about the fiscal situation and have relevant projections.
- **Citizen Engagement:** Expand opportunities for citizen feedback to rapidly identify weaknesses and problems in maintaining services.

## Detailed Recommendations Related to the Announced Package

- Deferred taxes and social contributions should be collected in full, starting in 2021, preferably in equal monthly installments. The number of installments should be calculated carefully and communicated clearly so that businesses can account for these costs next year(s). Also, this measure not to account for interest payments on deferred taxes.
- Clear definition for reduction in number of employees and in loss in revenues due to the COVID-19 pandemic needs to be set so that the risk of misinterpretation is minimized.
- Use the allocated budget for the SMEs support to focus first on most impacted sectors (like tourism; transport and other sectors) and explore options to create new designated programs (within the announced package) to help sectors not specifically mentioned earlier (like agriculture for instance) and to workers who worked informally.
- Speed up value-added tax (VAT) rebates for exporting businesses and conversely delay the collection of VAT from companies that import from abroad. This measure leaves more liquidity in the hands of companies involved in trade.
- Support in subsidized lending could be prioritized to export oriented firms.
- Consider co-financing of some additional programs or offer co-financing as an option to other levels of government and development partners. This could include, for instance, projects related to health infrastructure; environment; assistance to independent professions (arts and culture), etc.
- Provide tax concessions for workers in health and other emergency-related sectors in order to reward people for working extra hours and in potentially dangerous conditions.
- Once the economy returns to (near) normal functioning consider options to revise how the VAT is collected so that it imposes the least pressure on companies' liquidity.
- In consultation with local governments consider waiving or reducing the recurring annual tax on property.
- Delay some of the administrative requirements on businesses like: submission of final financial accounts for 2019 (which by default affects the submission of the corporate income tax records); also, delay the introduction of the announced test for independence of entrepreneurs, as well as deadline for implementation of QR and bar codes etc.
- Consider options how to assist those who worked informally and are excluded from announced measures.

## Additional Sector Specific Recommendations

The rest of the note suggests two areas that need a special focus – social assistance and energy.

### *a) Social Protection*

**The impacts of COVID-19 on household incomes and broader welfare status are likely to be substantial, and for specific poor and vulnerable groups disproportionate.** In addition to the direct health impact, the COVID-19 crisis will likely affect household welfare via higher food prices, increased health expenses, and reduced labor incomes. It is anticipated that a significant number of individuals will lose their jobs, especially persons with fixed-term contracts, seasonal workers, and those who have been engaged in the informal economy. Incomes of many vulnerable people above the administrative threshold established for the Financial Social Assistance (FSA) and people that are normally not beneficiaries of social assistance programs will be hit hard as well.

**Boosting existing social safety nets will enable Serbia to protect the most vulnerable citizens against the impact of the shock caused by COVID19 epidemic.** The system has demonstrated considerable crisis response capacities in the past. This has been evidenced in the aftermath of the 2008 financial crisis. The focus should be on cash transfers and unemployment benefits.

1. **Cash transfers:** The expansion of cash transfers, in particular Financial Social Assistance (FSA), could reduce the financial damage caused by the virus outbreak on the less well-off. Option are:
  - a. Increase of FSA benefit (presently the FSA benefit level is low, it corresponds to 31 percent of the average household expenditure of beneficiaries) by 20 percent for all FSA beneficiaries or those who are unable to work and single parent family. Duration of this enlarged support could last from 6 to 24 months. Annual cost of this measure to the budget would be approximately 200 million euros.
  - b. Automatic extension of FSA benefit to FSA beneficiaries who are able to work to a full year.
  - c. Expand social safety nets to new beneficiaries based on geographical targeting (poor regions disproportionately affected); and
  - d. Expand Child Allowance for all beneficiaries, or at least to single parent families.
2. **Unemployment benefits:** Generosity of benefits might be increased to respond to the crisis. In Serbia, unemployment insurance pays a benefit equivalent to 50 percent of the average salary in the last 6 months, with a floor equivalent of 80 percent of the minimum wage and a maximum benefit of 160 percent of minimum

wage. Given the exceptional situation of the crisis, and in anticipation that many middle-income individuals are at risk of losing their jobs, Serbia could consider increasing the maximum benefit ceiling. In addition, a one-off flat payment could be considered to disproportionately increase the benefit of low wage workers. At the same time, eligibility conditions could be temporarily relaxed, so that more vulnerable workers have access to these benefits. Serbia requires at least 12 months of contributions continuously or intermittently within the past 18 months. This requirement could be relaxed to 9 months in the last 18 to increase coverage for more vulnerable and less stable employees.

## **b) Energy Sector**

The short-term impact of COVID 19 is felt across all energy subsectors (electricity, coal, natural gas), mainly in the form of lost revenue caused by the sharp drop in demand in the industrial and commercial sectors combined with a decline in wholesale energy prices<sup>1</sup>. Main utility companies face major challenge. Currently, EPS cash reserves are covering less than one month of operating cost and the company may require access to liquidity support through short-term borrowing or transfer from the budget. Prices of natural gas have fallen by 20-40 percent across regional markets and the relative drop in demand can be expected to be even greater for Srbijagas given the greater prevalence of industrial and commercial customers for natural gas.

Short-term financial difficulties of utilities include:

- a. **Overall revenue shortfall** due to reduction in demand and delays in payments by consumers due to cash shortages on their side (both residential and commercial).
- b. **Inaccessibility/limited access to short-term credit lines.**
- c. **Inability to service debts** due to combination of revenue shortfall, possible local currency depreciation, and steep reduction of liquidity in capital markets.
- d. **Steep increase in costs of inputs** without matching increase in the revenues.

The government should help the EPS (and possibly Srbijagas) to ensure needed liquidity through short-term borrowing. This is especially relevant if the situation continues for more than 2-3 months. Beyond this immediate relief, the government should help EPS to improve liquidity through efficiency improvements and reduction of OPEX; and by further increase of tariffs for protected (residential) customers to at least 80% of market level. This is a favorable time for tariff adjustment due to recent weakening of energy market prices which reduced the gap between the commercial and residential prices.

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<sup>1</sup> It is important to mention that in the face of plummeting electricity demand, the Serbian Government has announced that it will defer full payment of the guaranteed long-term feed-in tariffs. Renewable energy producers (mainly wind power generators, but also a number of smaller biogas producers) will receive reduced payments corresponding to market level prices during the state of emergency but the duration of the Power Purchase Agreements (PPA) will be extended to compensate of the period of suspension.