Republic of Serbia

FISCAL COUNCIL

29 November 2024

ASSESSMENT OF THE PROPOSED BUDGET LAW OF THE REPUBLIC OF SERBIA FOR 2025

Summary:

Under the proposed budget, the fiscal deficit will widen in 2025 to 3% of GDP. After making a fiscal policy turnaround in 2024 – towards greater expansion (the increase in the budget deficit) - the Government of Serbia plans to pursue a similar fiscal policy in 2025. The proposed budget provides for a deficit of the Republic of Serbia of 3% of GDP (about EUR 2.7 billion) in 2025. This constitutes an increase compared to 2024, for which a fiscal deficit of 2.7% of GDP (about EUR 2.2 billion) has been planned in the recent supplementary budget. Government borrowing will be the main source of financing for the 2025 budget deficit. According to the Government's forecasts, Serbia's public debt in 2025 will go up in absolute terms from EUR 39.3 billion to EUR 41.9 billion, and this growth roughly corresponds to the planned fiscal deficit. However, a rise in borrowing in 2025 should not result in a higher share of public debt in GDP. More specifically, in 2025, Serbia's nominal GDP is also expected to grow relatively quickly, and at a slightly faster pace than public debt growth. As a result, the public debt to GDP ratio should decline slightly, from 47.9% of GDP at end-2024 to 47.5% at end-2025.

The 2025 budget introduces certain improvements at the technical level and credibly forecasts public revenues and public expenditures. The proposed budget features several significant positive developments in its technical aspect. It has made significant progress in the integration of indirect beneficiaries into the budget process (namely elementary schools and universities). All revenues and expenditures of these budget beneficiaries have now finally been included into the budget of the Republic, under adequate appropriations, and it has been announced that as of 2025 their collection and execution will be regularly monitored in the course of a year. An important novelty is the so-called green budget that has been drawn up for the first time, presenting a list of environmentally friendly projects. This new fiscal policy tool (which is becoming increasingly popular, especially in developed countries) should lay the foundation for better monitoring and alignment of fiscal policy with environmental protection and climate change objectives. In addition to technical improvements, the upside of the proposed budget is the fact that the good practice of objective forecasting of public revenue and public expenditure has been continued. In other words, there are no major risks of public revenue underperformance or public expenditure overrun in 2025.

Still, the underlying fiscal policy challenges in Serbia remain unresolved. This assessment is primarily related to the relatively high deficit level of 3% of GDP, as well as to the fiscal policy stance which, against the backdrop of the still relatively high inflation (and

economic growth that is close to its potential level), appears to be procyclical. More specifically, inflation in Serbia is still relatively high and, according to the latest available data, the year-on-year growth of consumer prices in October was 4.5% (the upper limit of the NBS target tolerance band). At the same time, core inflation (excluding energy, food, spirits and cigarettes) is even higher and stands at 5.5%. In addition to relatively high inflation, 2024 has seen a sharp deterioration of Serbia's external imbalance, i.e., the widening of the current account deficit. The estimate of the 2024 current account deficit of 4.4% of GDP as presented in the Explanatory Note of the Budget Law will almost certainly not materialize, i.e., Serbia's external deficit will probably exceed 5% of GDP. Domestic demand, fueled by fiscal expansion, grew at a considerably faster pace than GDP growth in the first half of the year. Such growth of domestic demand contributes to a rise in macroeconomic imbalances – and there is no need to boost it further through an even larger fiscal deficit. The projected fiscal policy stance in 2025, which implies an increased deficit, is not good, taking also into account that interest rates on borrowing are still fairly high.

The increase in the 2025 fiscal deficit is driven by higher current expenditures of the Republic. A comparison between the proposed budget and the Supplementary Budget for 2024 shows that public revenues are planned to go up by RSD 173 billion, and expenditures by RSD 224 billion in 2025 compared to 2024. However, we need to point out that a portion of the increase, a smaller one, on both the revenue and the expenditure side (of about RSD 15 billion) is a consequence of methodological factors, i.e., the above-mentioned improvement in the monitoring of indirect budget beneficiaries. A true picture of the economic changes introduced by the new budget can be obtained after excluding this effect. The planned budget revenue growth in 2025 (including the above methodological adjustment) is 7.3%, which is roughly in line with the projected nominal GDP growth (7.5%). On the public expenditure side, the planned growth of public investment in 2025 is 7.5%, which is also in line with both the forecast increase in public revenues and the nominal GDP growth. Consequently, the budget component directly driving the increase in the fiscal deficit from 2.7% of GDP in 2024 to 3% of GDP in 2025 is current expenditures (wages and salaries, purchases of goods and services, interest payments, transfers for pension benefits, subsidies, etc.). Their planned growth in 2025 (adjusted for methodological changes) stands at 9.2%.

The rise in current budget expenditures is mainly due to statutory and contractual obligations of the government, which have not been offset by savings on other items. The budget item with the highest growth in 2025 is interest expense. It is planned to grow by as much as 19%, reaching a level of about EUR 1.9 billion in 2025. The strong surge in interest expense is a consequence of the (nominal) increase in public debt over the previous years, as well as of the tightening of borrowing terms (higher interest rates). These expenses are now unavoidable, but they could have been prevented by a more responsible fiscal policy in previous years, as the Fiscal Council had warned (e.g. about the frequent non-targeted payments to households). The relatively sharp increase in pension expenditures (which can be identified in the budget item Transfers to the Pension Fund) is a consequence of the statutory pension indexation by 10.9% – and it is not arguable. The planned increase in the wage bill is 10.4% (taking into account the methodological changes). This increase is a consequence of the wage growth in most of the public sector by 8%, with a somewhat stronger pay raise for the Ministry of Education, and especially for the Ministry of Defense (higher expenditures for employees at the Ministry of Defense by about 18% have not been explained; it could be a consequence of the increase in the number of employees due to the introduction of compulsory military service, but a possible pay raise on top of the general indexation cannot be ruled out). The planned public sector wage growth, which is notably faster than economic growth, is not sustainable in the long run. However, in the 2025 case, it could be justified by the fact that it is permitted under the applicable special fiscal rules, as well as by the fact that wages in the private sector are currently growing at an even faster pace. Considering all of the above, it can be said that the above-mentioned upsurge in current public expenditures on interest payment, pension benefits and wages and salaries of the general government employees was difficult to avoid. However, these increases could probably have been offset by streamlining the remaining budget items, which did not happen in the proposed budget for 2025. For instance, by resolving the fate of PE Resavica, which has been postponed year after year, scrutinizing expenditures under the item Net lending (which is in general non-transparent), implementing savings on purchases of goods and services, etc.

An exceptionally high level of public investment is maintained in 2025, amounting to 7.4% of GDP (for the general government). The proposed 2025 budget provides for capital expenditure of the Republic in the amount of RSD 613 billion (about EUR 5.2 billion). When we add to this about RSD 150 billion for the capital budget of other levels of government (primarily local self-governments), it is clear that the plan for consolidated general government investment is to reach as much as RSD 763 billion (about EUR 6.5 billion) in 2025. In terms of share in GDP, this would mean that public investment in 2025 will amount to 7.4% of GDP, making Serbia (along with Estonia) a record holder in Europe. The analysis of the budget reveals three investment priorities of the Government in 2025. The bulk of the investment is earmarked for: the construction of transport infrastructure (about EUR 2 billion); military equipment (about EUR 1 billion); and the EXPO 2027 project together with the National Stadium and linear infrastructure (about EUR 700 million). The very high level of public investment of 7.4% of GDP emphasizes the need for better regulation and improvement of public investment policy in Serbia – the topic already extensively elaborated upon by the Fiscal Council (please see the report *Public Investment Policy in Serbia: Situation Analysis and Recommendations for Possible Improvements* of June 2024). A positive shift toward greater transparency has been made in the recently adopted Revised Fiscal Strategy. For the first time, it features a table with information on the estimated values, funds invested until end-2023, and planned allocations in the 2024-2027 period, for 56 investment projects worth more than EUR 20 million each (except for investments in the field of defense and security). This change is certainly commendable, but it must also be noted that many additional improvements are still needed in the area of public investment - for example, almost all large-scale infrastructure projects are currently implemented following special procedures, being partially or completely exempt from the overarching regulation.

Pressures to widen the fiscal deficit will likely mount in the coming years, and the government will need to resist them in a timely fashion. In simple terms, the proposed 2025 budget could be described as largely driven by the inertia of 2024. More specifically, the budget for 2025: 1) has accepted the unavoidable increases in expenditures for interest payment, pension benefits, and public sector wages and salaries; 2) has retained exceptionally high allocations for public investments; and (3) has not cut the remaining expenditures substantially. This then resulted in the (economically undesirable) widening of the fiscal deficit, while postponing the implementation of the general fiscal rules (which was scheduled precisely for 2025). It is not advisable for a similar inertia in the management of public finances to continue in 2026 and beyond, especially since some of the one-off budget revenues from 2025 (such as the sale of licenses for the use of the 5G network) will be exhausted by then. Therefore, the Government should very carefully analyze fiscal trends and risks in the medium term in order to prepare the necessary measures and reforms in a timely manner. The planned 2025 fiscal deficit of 3% of GDP is not small for Serbia and its further widening in the coming years would be very dangerous.

The amendments to the tax laws which are proposed together with the budget do not contain significant changes to the existing tax policy. In line with the well-established practice, the budget for next year is accompanied by a number of amendments to tax laws: *the*

Law on Excises, the Law on Personal Income Tax, the Law on Compulsory Social Security Contributions, the Law on Property Tax, the Law on Value Added Tax (VAT), the Law on Corporate Income Tax and the Law on Republic Administrative Fees. Although the proposed changes are numerous, they do not substantially change Serbia's current tax policy. Changes in wage taxation and changes in excise policy are the only changes with a more significant fiscal impact. In 2025, the fiscal burden on labor will be reduced through an increase in the tax allowance from the current RSD 25,000 to RSD 28,423 - which the Fiscal Council assesses as an economically sound and justified measure. Unlike the assessment regarding the wage tax, the assessment of the proposed changes in excise policy is more ambivalent. On the one hand, broadening the coverage of excise duty on tobacco is in line with good taxation practices, while on the other hand, the planned cut in the amount of the excise duty on diesel fuel for transport companies (higher refunds) is contrary to the international practice of eliminating (or reducing) tax incentives for fossil fuels. Besides amendments to the tax laws, it is important to also point out that the 2025 budget has not brought significant improvements in tax policy, which were announced. More specifically, the amendments to *the Budget System Law* have postponed the presentation of tax expenditures in the budget plans for another two years (although it was supposed to start with the budget for 2025). Data on tax deductions and exemptions are of great importance for the budget process and tax policy analysis. Therefore, we believe that this postponement should not have occurred. If no technical possibilities were currently in place to present tax expenditures in detail by each of the categories, at least the most generous ones could have been indicated (as was done, for example, in the 2010-2012 period), only to gradually improve the reporting in the future.

The recent major GDP revision conducted by the Statistical Office of the Republic of Serbia (*Ser*. RZS) has significantly changed a large number of fiscal aggregates in Serbia. In October 2024, the RZS carried out a major revision of GDP data. This revision significantly increased all official data on Serbia’s nominal GDP from 1995 to 2022, and similar upward GDP adjustments were consequently carried forward to the subsequent years. Thus, according to the new data, Serbia's GDP in 2024 is estimated at around EUR 82 billion, which is higher than earlier estimates by as much as EUR 5.6 billion (before the revision, Serbia's GDP in 2024 was estimated at EUR 76.4 billion). One of the important consequences of the GDP revision was a significant fiscal relief for Serbia. First of all, the share of public debt in GDP has automatically dropped by more than 4 percentage points, which is a big change. More specifically, public debt at end-2024 is now estimated at 47.9% of GDP, and previously the government estimated it at 52% of GDP. All other fiscal aggregates measured as a ratio to GDP (budget deficit, pension benefits, public sector wages and salaries, etc.) have also undergone proportional changes. Bearing in mind the importance and significance of high-quality and timely GDP data, the Fiscal Council calls on the Government to allocate more resources to support the RZS, i.e., to strengthen its operational and professional capacity. We recall that this is already the third GDP revision in the last ten years, and that each of these revisions significantly increased GDP. In this manner, Serbia’s macroeconomic and fiscal image has been changing unpredictably and substantially, and certain economic policies have suddenly become questionable. Major changes in what is probably the most important macroeconomic indicator, have been taking place in Serbia for a decade now, and are not common in other European countries. They make it much more difficult to adequately conduct economic policies – which in well-organized countries must be based on high-quality and timely data.