Republic of Serbia
FISCAL COUNCIL **2 December 2022**

ASSESSMENT OF THE PROPOSED BUDGET LAW OF THE REPUBLIC OF SERBIA FOR 2023

Summary:

The 2023 budget features moderate improvements in fiscal policy, though still overshadowed by huge expenditures to cover the losses of the state-owned energy sector. The proposed fiscal deficit in the 2023 Budget Bill is relatively high, amounting to RSD 264 billion (3.3% of GDP). When this deficit is compared to the one of 3.9% of GDP planned in the recently adopted supplementary budget for 2022, it is possible to say that, after all, the budget for 2023 is gradually taking public finances in the right direction. The main reason why the fiscal improvements could not have been stronger lies in the persisting hefty loss of public enterprises in the energy sector (EPS and Srbijagas) resulting in a huge fiscal expenditure in 2023 as well. About EUR 1.2 billion (1.7-1.8% of GDP) has been directly appropriated in the budget for this purpose - which means that more than half of the 2023 fiscal deficit is a direct consequence of the unsuccessful business operations of EPS and Srbijagas. However, even this amount does not include all the costs that taxpayers have to bear because of these companies. The budget has also given the possibility to the government to issue up to EUR 1 billion in new guarantees for their borrowing, formally not included in the deficit for 2023. However, public enterprises as a rule did not repay such guaranteed loans in the past; hence, it is safe to assume that this, too, could be a future cost to taxpayers. Excluding the huge expenditures for EPS and Srbijagas, the budget is generally adequate. Public revenue and public expenditure (excluding the energy sector) are balanced for the most part, public investment spending has been kept at a high level, and the gradual reduction in the tax wedge has continued. Another important positive novelty in the 2023 budget is that after three years, the cash payments of non-targeted support for households, which were misguided from both an economic and a social policy perspective, are finally eliminated.

The indisputably largest problem of Serbia's public finances is the huge expenditure for EPS and Srbijagas, which is yet again non-transparently presented in the budget. The bulk of budget expenditure for public enterprises in the energy sector is posted under the item *Outflows for acquisition of financial assets* (for policy purposes). As a rule, this budget item amounts to RSD 5-10 billion in "normal" times, while in the 2023 budget, as much as RSD 117 billion is allocated to it, i.e., about EUR 1 billion. Obviously, the source of such a surge in the expenditure is the unsuccessful business operation of EPS and Srbijagas, for which the lion's share of these budget outflows is earmarked (probably around EUR 900 million). Completely precise

data, however, is not available because the Government has remained nontransparent in the presentation of these expenditures (the same as in the supplementary budget for 2022). As a consequence, the exact amount allocated from the budget to public enterprises in the energy sector is not known, nor is it known how much of it goes to EPS and how much to Srbijagas, how exactly their losses were incurred, for what exact purposes the budget allocations will be used or other relevant information. In addition to this, the budget allocates another EUR 85 million to EPS for the purchases of mining machinery, while also featuring a newly added subsidy programme in the amount of around EUR 130 million, earmarked for mitigating the consequences of the energy crisis (whose concrete function remains unknown). Moreover, there is also EUR 90 million for the repayment of the EUR 200 million guaranteed loan that Srbijagas took out in the spring of 2022 (and will not be able to repay in 2023). Therefore, the direct budget cost of public enterprises in the energy sector is planned at the level of around EUR 1.2 billion in 2023. In addition, as we have already mentioned, the budget provides the possibility for new borrowing by these companies against a government guarantee in the total amount of up to EUR 1 billion - which will most likely become a future budget expenditure. This too has not been explained to taxpayers.

The budget expenditures for EPS are primarily the consequence of the gross mismanagement of this company in previous years, rather than of the global energy crisis. The main reason why EPS is currently unable to operate without financial assistance from the government is related to the fact that it has been brought into a situation where it is miles away from meeting domestic needs with its electricity production due to almost unbelievable errors in its management. More specifically, EPS has failed to open a new coal mine in Kolubara in a timely fashion, before exhausting the old mines. This means that the quality of coal in the existing mines has been gradually declining after many years of exploitation, and in 2021 it fell below the technical minimum required for the operation of TENT. As a result, EPS now faces huge operational and financial problems. At the operational level, in order for TENT to be capable of producing electricity in the first place, it is necessary to purchase and deliver both fuel oil and coal of a better quality, which are then mixed with the poor-quality lignite mined from Kolubara. All this not only pushes up production costs and generates massive environmental pollution, but also fails to secure efficient production. Compared to previous years, the output of EPS has sharply declined since late 2021, in part due to a major accident that occurred in one of the plants in December 2021. The consequence of the reduced production, coupled with higher operating costs, is a heavy financial loss for EPS. More specifically, EPS now has to import large quantities to cover the electricity shortfall, at prices that are currently at their all-time high and stand at more than €200/MWh (several years ago, the going price was around €50/MWh). However, we emphasize once again that the global energy crisis is not the main reason for EPS's problems - because these costs would not have been incurred if EPS's mismanagement had not seriously undermined its own production in the past few years.

The electricity price hike will considerably reduce the financial losses of EPS in 2023, but we estimate that EPS will still continue to receive substantial budget support. The most recent reliable data on EPS' operations which is available indicates that this company made a loss of EUR 680 million in the first nine months of 2022, which will probably go up to EUR 850-900 million by the end of the year. In 2023, EPS' losses will decline considerably and probably come down to around EUR 300 million. The main reason for lower losses is the increase in electricity prices on the domestic market, which will on average be 20% higher in 2023 compared to 2022. The price of electricity for households already went up by about 11% in September 2022 (a 6.5% hike in the base price with roughly an additional 4.5% for adjustment in the share of renewable energy sources), while a recent government decision dictates an additional increase of 8% in January 2023. For companies, the price cap was raised in September 2022 from €75/MWh to €95/MWh. Besides the increase in prices, the lower losses of EPS in 2023 will also result from the expected higher production of hydroelectric power plants (because 2023 will probably not see a drought as was the case in 2022), as this will reduce expensive imports to a certain extent. However, EPS apparently needs an even bigger financial injection from the budget than the amount required to just cover its huge losses. For instance, it is uncertain how the (long overdue) opening of a new coal mine will be financed. It is hard to believe that EPS can finance this undertaking from its own funds. Because of the scale and importance of government expenditures for EPS, detailed answers to these and similar questions should have been provided in the rationale of the budget law, but this was not the case.

EPS is likely to become a profitable company as of 2024, but unless fundamental reforms are promptly initiated, it will continue to pose a persistent risk to public finances. The financial "bleeding" of EPS will most likely stop after the opening of a new coal mine, which is slated for 2024, or perhaps late 2023. When that happens, EPS will revive its struggling production and will no longer need to import huge quantities of expensive electricity (and coal). In fact, at that point EPS will almost certainly start making profits instead of losses - because its expenses will automatically fall sharply, and revenues will remain quite high due to relatively strong increases in electricity prices in 2022 and 2023. Yet, the opening of a new mine on its own, even coupled with the price increases, will not transform EPS into a lastingly successful company. Lignite, on which the production of EPS is now based, is an unsustainable energy source in the long run, and the increase in revenue due to a higher sales price could easily be absorbed by internal dysfunctionalities of the company (which has happened before). This is why EPS has to embark upon an energy transition as soon as possible, to resolve the issue of overstaffing and the generally poorly structured remuneration and employment system, to stop the draining of funds to numerous related enterprises, to cut back the huge distribution grid losses and thefts, to improve its public procurement processes, to cut the huge amount of pollution it emits into the air and solve numerous other problems. In the absence of radical reforms whose implementation would finally have to start in 2023, EPS will continue to be the biggest and chronic "patient" of Serbia's public finances, which is bound, sooner or later, to require another large-scale budgetary intervention.

Srbijagas will continue to generate losses due to the remaining difference between the purchase and the sales price of gas, which the Government should eliminate as soon as possible. The main reason for the unsuccessful operation of Srbijagas (and consequent budget expenditures) lies in the fact that this company purchases gas at a price that is higher than the selling price on the domestic market. After the latest adjustments of the final gas price in Serbia by slightly over 20% (9% in August 2022 and an additional 11% as of January 2023), the losses of Srbijagas will be lower in 2023, but not yet eliminated. For a better understanding of the broader context of these price increases, comparative data can be used, according to which the gas price paid by households in the countries of Central and Eastern Europe went up by almost 80% on average in the previous year, while the price for businesses is more than two times higher. What is particularly problematic here is the unsound economic principle that is applied in Serbia – to shift the costs of the increase in the purchase price of gas to all taxpayers rather than to consumers. Justifications for this policy, such as those that the increase in gas prices will undermine the competitiveness of the Serbian economy, do not hold up, because gas prices for competitors in Europe are already sharply increased. There is no economic rationale for the fact that Serbia's citizens are paying, for example, the costs of gas price increases to the company HBIS GROUP (former Iron and Steel Works Smederevo), which is paying about EUR 30 million for gas on an annual basis - especially since this company posted profits in 2021 of EUR 200 million. Similarly, there is no economic justification for the fact that all citizens of Serbia, including the poor without a gas connection, have to pay the bills of individuals who consume that gas, among whom there are certainly those with higher living standards who objectively do not need such assistance. Government intervention is economically justified and fiscally rational only in particular cases, for example in the case of companies that have high energy costs and produce for the domestic market, or in the case of socially vulnerable households – but not for all.

Excluding the burning problems of public enterprises in the energy sector, the remaining part of the budget can generally obtain a positive assessment. If it had not been for the expenditures on EPS and Srbijagas, Serbia's fiscal deficit in 2023 would have been quite acceptable, at a relatively low level of 1.5% of GDP. Furthermore, it is very likely that in the "non-energy" part of the budget, a slightly better fiscal result will be achieved in 2023 compared to the plan - because both public revenue and public expenditure have been forecasted not only credibly, but also very cautiously. With regard to public revenues, each individual forecast for 2023 is, as a rule, lower than the forecasted trend of the corresponding tax base. This method for planning public revenues is absolutely adequate against the current backdrop of heightened macroeconomic uncertainties. The same applies to public expenditures, where sufficient room has also been left for possible contingencies. For example, interest payments are planned a bit more generously than what is likely to be required, but such a buffer is welcome at a time when a new strong and steep surge of global interest rates in the near future cannot yet be ruled out. Likewise, a more detailed analysis reveals the existence of a certain buffer on transfers from the state budget to the National Health Insurance Fund. This is also understandable, especially considering the experiences with the coronavirus pandemic in previous years. We also observed a bit more generous expenditure planning in the case of purchases of goods and services, transfers to other compulsory social insurance funds, and some specific public expenditures (e.g., for the costs of guarantee schemes issued during the corona outbreak). The thing that we would like to emphasize here as particularly important is that potential savings in the budget (which are definitely possible in 2023) should not be spent on new policies, which was often the case in previous years. The fiscal deficit, which amounts to over 3% of GDP after energy costs, is too high for Serbia and any potential savings in relation to the proposed budget plan should primarily be used for reducing the deficit rather than for new public spending.

The planned increases in pensions and public sector salaries and wages are consistent with the new, revamped fiscal rules. After a decline in pensions and public sector wages and salaries in real terms caused by the strong acceleration of inflation in 2022, in 2023 they are planned to grow slightly faster than they usually do. General government wages and salaries are projected to go up by 12.5%, except for the wages and salaries of professional military personnel, which will increase by 25%. Expenditure for employees in the state budget will nevertheless go up slightly less than that, i.e., about 11%. The reason for this is that the tax burden on labor will be reduced simultaneously and, moreover, in 2023 there will no longer be any extraordinary expenditures from 2022 under this budget item (e.g. for the organization of elections). Our assessment is that the projected wage increase for public sector employees is well calibrated because it should enable their moderate real growth (since the forecast of average inflation in 2023 stands at around 11%). Nevertheless, the perpetual criticism of the Fiscal Council that the Government should finally focus more efforts on the permanent regulation of the wage and employment system in the public sector, which is plagued by numerous weaknesses, still stands.

When it comes to pensions, their slightly higher growth is planned in 2023, amounting to 12%, after the 9% increase in November 2022. Essentially these pension increases can also receive our positive assessment as economically justified, all the more so since for most of 2022 (until their first increase in November) pensions were reduced more than wages in real terms. Likewise, systemic pension increases, coupled with the introduction of their modified indexation as defined by the new fiscal rules, are a much better solution from the economic standpoint than one-off ad hoc payments that were very common in previous years. At the general government level (not presented directly in the Budget Law), government spending for both pensions and wages in the public sector in 2023 will be at an acceptable level of slightly below 10% of GDP. This is also in conformity with the new and improved fiscal rules (see chapter: “Assessment of the New Fiscal Rules”).

The 2023 budget has kept a very high level of public investment, but its structure has undergone significant changes. The total public investment of general government is also not fully identifiable in the Budget Law, among other things, because a portion of these funds is posted under transfers (e.g. transfer for the construction of clinical centers), while some investment projects are implemented at other levels of government (e.g. local governments). A more detailed analysis shows that the 2023 budget has planned a very high level of general government public investment of almost 7% of GDP (EUR 4.8 billion), which is similar to that of 2021 and 2022. High allocations for public investment are generally positively assessed by the Fiscal Council - because it is the type of public spending that has the highest impact, boosting economic growth the most, and it is also a necessary expenditure, because the quality of basic infrastructure in the country is at an unsatisfactory level. However, it can be observed in the 2023 budget that the composition of public investment is starting to change more significantly, which puts into perspective the overall positive assessment of government investment spending. On the one hand, investment in healthcare, which was particularly increased during the coronavirus pandemic, is going down; some larger-scale individual projects are being completed (construction of a section of the ring road around Belgrade); and there are also some other significant cuts in terms of the budget balance, such as allocations for the high-speed railway line to Hungary. On the other hand, big new investment projects such as the National Stadium, the subway in Belgrade, and the construction of a new bridge over the Sava in Belgrade, are prominently featured in the budget.

The system for selecting, implementing and monitoring infrastructure projects in Serbia should be significantly enhanced and more transparent. Several years ago, allocations for public investment were much lower than now, and those limited funds, as a rule, were earmarked for indisputable priorities, such as the construction of the most important transportation corridors. However, such practice has now changed considerably, as confirmed by the 2023 budget. First, the amount of funds set aside for public investment is several times higher (e.g. in 2017, public investment amounted to a mere EUR 1.1 billion, and in 2023, it will be more than 4 times higher). At the same time, projects that require a more detailed explanation for taxpayers now hold large allocations within total public investments. One such example is the planned construction of the National Stadium, which will cost around EUR 65 million in 2023 alone, whereas its economic profitability has not been publicly demonstrated to taxpayers. Naturally, the Fiscal Council does not oppose to investing in sports facilities *a priori*, but for such large projects financed by the citizens of Serbia, the Government would have to share much more details. For instance, why it decided to invest money there, and not in stepping up the construction of utility infrastructure, for which insufficient funds are planned even in 2023 (despite the planned increase). Within the assessment of public investment, it should certainly not go unnoticed (and without praise) that the Ministry of Public Investment (formerly Office) finally presented the structure of its capital investment projects in the budget - after many years of disapproval from the Fiscal Council regarding the former practice, which was completely non-transparent.

The 2023 budget brings major changes in the tax policy, which we generally assess as favorable, with several minor exceptions. The proposed budget incorporates the effects of numerous amendments to tax laws (which are also submitted to the Parliament and considered on an individual basis). Amendments to the following laws were proposed: Law on Personal Income Tax, the Law on Compulsory Social Insurance Contributions, the Law on Property Taxes, the Law on Fiscalisation, the Law on VAT, the Law on Republic Administrative Fees, the Law on Tax Procedure and Tax Administration, while certain additional amendments to the Excise Law have been announced. Of these changes, two are the most important from a fiscal point of view – further reduction in the tax wedge and relaxation of the excise policy against the backdrop of the energy crisis and rising inflation.

- The fiscal relaxation of the tax burden on wages in 2023 will be implemented by reducing the contribution rate of pension and disability insurance from 25 to 24% and by increasing the personal tax allowance from RSD 19,300 to 21,712. This change is supported by the Fiscal Council, although it will result in a decline of public revenues by around RSD 40 billion. Empirical analyses namely show that this is the right direction of economic policy which leads to higher competitiveness of the domestic economy and employment growth (if implemented in a fiscally responsible manner). Also, we suggest continuing with the further reduction in the tax burden on wages in the coming years and implementing it with a stronger increase in progressivity.
- Keeping the reduced 2022 excise duties on fuel in 2023 as well, while limiting the growth of other excise duties, is an understandable measure against the backdrop of rising inflation and steep fuel price growth - especially since there are other European countries that implement a similar policy. Nevertheless, we recall at this point that, instead of general pricing policies, it is more economically superior and fiscally responsible to increase targeted benefits to socially vulnerable citizens. In this set of tax measures, the temporary suspension of the statutory increase in excise duties on cigarettes by actual consumer price inflation in 2022 has also been announced. This is not in keeping with the strategic commitment of the government to reach the minimum cigarette excise tax requirement of EUR 1.8 per pack, which is defined by the EU Directive and accepted in Serbia.
- Finally, although it is not overly significant in terms of budget balance, we assess that the proposed introduction of innovative solutions for the taxation of personal income (paid based on self-assessment) will further complicate an already excessively complex system. That is why we recommend considering and implementing a comprehensive reform, instead of such partial changes, which would introduce a modern personal income tax system that would treat all forms of income in a consistent and uniform manner.

It is good that the practice of adopting and publishing the Annual Accounts has been established, but this document should be significantly improved. Along with the 2023 Budget Bill, the Bill on the 2021 Annual Accounts was also submitted to the Parliament for consideration. In accordance with its statutory duties, the Fiscal Council has analyzed this Bill, too. After several years of hiatus in the consideration of the Annual Accounts (and even its publication in some years), since 2019 this report has been submitted to the Parliament on a regular basis, which the Fiscal Council welcomes. The annual accounts for 2021 bring some new information about the execution of the budget in that year, which refers primarily to indirect budget beneficiaries (schools, universities and other institutions). These beneficiaries generate (and spend) their own revenues, which are now visible for the first time since they are not included in the regular reporting of the Ministry of Finance. The total amount of these revenues is around EUR 480 million, which is not a small amount. Therefore, the recommendation of the Fiscal Council is to find a way to include this part of the budget into the regular, timely reporting. Similarly, in the annual accounts, for the first time, one can also see part of spending through the current budget reserve (about EUR 190 million), which was not publicly available in real-time. The main weaknesses of the Annual Accounts are related to their lack of information and transparency. In the part of the annual accounts, which should explain why certain budget beneficiaries departed from their spending plans, there is practically no useful information (despite the fact that this section occupies 150 pages). The non-transparency of the Annual Accounts is another major problem, which is particularly pronounced with regard to the net lending account. Namely, it is only possible to see the total amount of payments without key data to which companies and on what terms the loans from the budget were approved, if and when the repayment of funds to the budget is expected, etc. A similar unfavorable assessment can be given for the insufficiently transparent presentation of subsidies for attracting investment and for expenditures on fines and penalties.