Republic of Serbia
FISCAL COUNCIL
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OPINION ON DRAFT FISCAL STRATEGY FOR 2023 WITH FORECASTS FOR 2024 AND2025

Summary:

Draft Fiscal Strategy represents an important anchor for fiscal policy at a time of increased global uncertainty. The Fiscal Strategy is the Government's main document for conducting fiscal policy in the medium term. However, the Draft Fiscal Strategy for 2023 with forecasts for 2024 and 2025 has been prepared in specific circumstances, due to which it has certain objective limitations. First of all, it is still impossible to have a precise overview of how Serbian economy and fiscal policy will be affected by the growing global instability caused by the war in Ukraine, together with the energy crisis and soaring food prices. Also, this document has been prepared before the formation of a new Serbian Government, which has yet to be given the mandate to conduct the country's economic policy in the upcoming four years. Although all of these factors limit the Strategy's capacity to define the medium-term fiscal policy in precise detail, it is very important that the preparation of this document has not been postponed (which was frequently the case in previous crises). Development of the strategic document for conducting fiscal policy under such circumstances is actually a very significant and positive step which signals that, even in situations of increased uncertainty, there is institutional stability, that the Government has clear guidelines for managing the budget and public debt, and that it still keeps the implementation of structural reforms on its medium-term agenda.

The most important message of the new Fiscal Strategy is that, despite the growing uncertainty, the Government will not give up budget stabilization and public debt reduction in the medium term. The plans laid out in the Strategy envisage that the general government deficit will continue to gradually decrease in the upcoming years, from 3% of GDP in 2022, to 1.5% of GDP in 2023, then 1% of GDP in 2024 and finally 0.5% of GDP in 2025. The Fiscal Council sees the projected fiscal deficit path as an appropriate strategic goal. *Firstly*, the fiscal deficit of 0.5% which is the medium-run target represents a budget deficit level that is sustainable in the long run and guarantees long-term stability of public finances. *Secondly*, reduction of the fiscal deficit would also lead to a gradual decrease of the public debt-to-GDP ratio, which should drop to about 50% of GDP at the end of 2025. according to current plans. A gradual decrease of the excessive public debt, which is currently at around 55% of GDP, is particularly important at this moment because of the almost certain rise in interest rates in the future. Namely, if Serbia does not decrease its public debt, the budget expenditures on interest, currently at about a billion Euros, are going to grow relatively quickly in the upcoming years due to rising borrowing costs – thus increasing this non-productive government expenditure, which would then put even more pressure on the country's public finances.

The largest shortcoming of the Strategy is its failure to properly analyze the fiscal risks and problems of SOEs in the energy sector (Srbijagas and EPS). Although the

Strategy draws a lot of attention to the global energy crisis, it does not recognize that the key reason why this crisis has hit Serbia so hard lies in the long-lasting mismanagement of the state-owned companies in the energy sector. More concretely, Srbijagas has been delaying the construction of a gas storage facility of sufficient capacity for years; on top of that, at the start of the heating season, even the existing storage facility was not filled anywhere near its full capacity. These shortcomings have already cost the Serbian budget about 500 m Euros (roughly 300 m Euros in 2021 and approximately another 200 m Euros in 2022) and Srbijagas will very likely remain a (somewhat smaller) burden for the budget in the years to come. Enormous problems in Elektroprivreda Srbije (EPS) were caused by many years of mismanagement and insufficient investment in the production capacities and distribution network. This is the main reason why EPS can no longer produce enough electricity to meet domestic needs, which means that electricity must now be imported (at very high prices). EPS has so far been able to cover these costs by taking out loans, which is why these costs have not yet spilt over on the budget, but this company still represents an enormous fiscal risk. Namely, EPS is a state-owned company whose poor performance generates annual losses at a scale of hundreds of millions of Euros – which is unsustainable – so an intervention from the budget is quite plausible. For these reasons, we argue that the main drawback of the Fiscal Strategy is the missed opportunity to consider the aforementioned problems of state-owned companies, i.e., this document fails to quantify the costs, assess risks for public finances and, to the very least, lay the foundation for a response plan.

The Fiscal Strategy envisages notable improvement of the budget structure in the medium term. The Strategy proposes a visible drop of in the share of the national budget in GDP in the medium term – public revenues from 42% of GDP in 2022 to about 40% of GDP in 2025, and public expenditures from 45% of GDP to about 40.5% of GDP. Public revenues and public expenditures at about 40% of GDP are the common standard in Central and Eastern European countries, so we see this as a good target for Serbia. It is also good that the burden of the necessary fiscal deficit decrease in the medium term comes from the decrease in the share of public expenditure in GDP, i.e. that no increase in tax rates is planned. Finally, another positive aspect of medium-term plans presented in the Fiscal Strategy is that public investments are foreseen to remain at a relatively high level of 6 to 7% of GDP.

The medium-term public revenue plan presented in the Strategy is credible, but it will strongly depend on the macroeconomic trends that are currently quite difficult to predict. The public revenue projections in the Strategy have been done in accordance with good budgeting practices. This means that the public revenues are projected, in principle, in line with the forecasted macroeconomic framework and, we might add, quite cautiously (conservatively). Any significant departure of the public revenues from the plan will depend primarily on the future macroeconomic trends that are quite uncertain. The Strategy introduces some revisions in the projection of the macroeconomic framework due to global instability – decreasing the expected economic growth rate, increasing the inflation rate and increasing the current account deficit. GDP growth has been reduced from 4.5% to 3.5% for 2022 and from 5% to 4% annually in the medium term. The average inflation rate for 2022 has been increased to 9.2% (from 3.7 in the previous Strategy) and is expected to be gradually lowered to 3% by 2025. The current account deficit forecast for 2022 has been increased from about 4% of GDP to about 7% of GDP, with a gradual decrease to 6% of GDP in 2025. Forecasting macroeconomic trends in conditions of growing global uncertainty is difficult and cannot be entirely reliable, but the projections in the Strategy are in line with the latest forecasts of the relevant international institutions (IMF, European Commission) for Serbia and we view them as the best that are currently possible.

The projected public expenditure decrease is achievable, but in some segments it has not been credibly planned. The decrease in the share of public expenditures in GDP will, to a great extent, occur automatically as the one-off payments and extraordinary expenditures will cease after 2022. The planned decrease of social transfers comes from the execution of assistance to pensioners, in the amount of RSD 20,000 (which were paid out in February 2022), other current expenditures decline as the non-selective payments to other categories of the population are discontinued (in 2022, two tranches of EUR 100 to each person between the age of 16-29), while expenditures for goods and services decline as the need for unplanned major procurements in healthcare services ceases to exist. What is disputable, however, is whether the planned decrease of subsidies and net budgetary loans will decrease from 3% of GDP in 2022 to 1.9% of GDP by 2025. This decrease rests on the assumption that no additional extraordinary budget assistance shall be paid out to public and state-owned enterprises, which cannot be seen as credible without a set of measures to improve their business performance. Something similar can be said about the forecasts of public sector wage bill, which is expected to be maintained at a constant level in the medium term (9,8% GDP). Such plans were also made in previous Strategies but were often disrupted by higher increases in the public sector salaries than initially planned. The projected path of public investments looks good “on paper” but cannot be evaluated more thoroughly since concrete projects remain unknown, as do the Government’s investment priorities. Finally, new unexpected expenditures to support the economy and population due to growing energy and food prices are certainly possible. The Strategy mentions that such interventions might happen, but explicitly states that they will be accurately targeted and limited. However, the Government made similar announcements in mid-2020 regarding budget assistance during the healthcare crisis – but this assistance ended up being mostly non-selective, which led to it being an excessive and economically irrational budget expenditure.

The structural reform plan is not presented in sufficient detail, not quantified nor integrated in fiscal forecasts. The plan for structural reforms has mostly been copied from the previous Strategies and shares their weaknesses, which we pointed out in our previous assessments. The main point we emphasize at this time is that structural reforms are generally neither quantified nor brought into connection to the fiscal forecasts. For instance, the planned reform of public sector employment would certainly resolve the problem of staff shortages in certain segments of the public sector (healthcare, inspections). Hence, merely outlining this reform in general terms, which was done in the Draft Fiscal Strategy, is not sufficient; instead, it is necessary to accurately quantify the missing staff in the public sector and subsequently include the costs of their salaries in the projections for government expenditures in the upcoming years.

The revised Fiscal Strategy will most likely encompass significant changes compared to the Draft, but it would be quite important to keep the planned fiscal deficit reduction in the upcoming years. According to the budget calendar, the Government should prepare a revised Fiscal Strategy in the second half of the year. The revised Fiscal Strategy, as a rule, is derived from the Draft, but in 2022 the final document will likely contain more extensive changes than it is usually the case. First of all, the revised Strategy should be completed after the supplementary budget for 2022 has been adopted, and thus accommodated to organizational changes which will take place after the formation of new Government. Besides that, the revised Strategy would need to take into account the significant changes in public revenue and public expenditure compared to the initial budget, which are already certain at this time. Furthermore, both the short-run and medium-run macroeconomic forecasts will become far more certain in the upcoming months as macroeconomic indicators from the period following the outbreak of the war in Ukraine become available. A matter of critical importance, however, when developing the revised Strategy, should be to retain the plan to balance the budget in the medium term, as well as the resulting reduction of the debt-to-GDP ratio. Maintaining and then implementing such a plan is of vital importance for the medium-term fiscal stability of the country.