Republic of Serbia
FISCAL COUNCIL
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OPINION ON THE DRAFT FISCAL STRATEGY FOR 2022 WITH FORECASTS FOR 2023 AND 2024

Summary:

The Fiscal Strategy envisages good medium-term fiscal policy objectives, in general. After a fiscal deficit surge during the healthcare crisis of 2020 and 2021, the Fiscal Strategy draft envisages gradual balancing of public finance in the medium term. The fiscal deficit is planned to decrease from about 7% of GDP (the plan for 2021), to 3% of GDP in 2022, continuing the declining trend to 1% of GDP in 2024. Such deficit decrease will reverse the currently upward public debt trend, i.e. the public debt is planned to decrease from 60% of GDP to about 55% of GDP by the end of 2024. The planned budget balancing would be implemented in an economically sound way, with no sudden shocks: by controlling the increase of pensions and salaries in the public sector and decreasing subsidies and other current expenditures, whereas the public investments would be maintained at a very high level of over 6% of GDP. On the public revenue side, no tax increase has been planned – on the contrary, it was announced that, if fiscal trends turn out better than expected, the opportunity would be used to decrease the tax burden on economy. Finally, we see macroeconomic forecasts from the Strategy as appropriate, at this time. Taking all this in consideration, the Government's medium-term plan is generally acceptable – Fiscal Council's objections to the objectives in the Strategy and the methods envisaged for their achievement are minimal. However, the main question is whether this plan will be consistently implemented. This is why the main recommendations of the Fiscal Council for the improvement of the Draft Strategy are aimed at improving its credibility.

The new Fiscal Strategy Draft is very similar to the previous Strategy for 2021 with forecasts until 2023 (which was abandoned in 2021). The main medium-term objectives of the Draft Fiscal Strategy for 2022 with forecasts until 2024 are almost identical to those that were already planned in the previous Fiscal Strategy (for 2021 with forecasts until 2023), adopted in December 2020. The main difference is that they have been postponed by a year. Reaching the general government deficit of 1% of GDP is now planned for 2024, which had been planned for 2023 in the previous Strategy. Similarly, decreasing the public debt down to little over 55% of GDP was originally planned for 2023 and is now postponed for the end of 2024. The previous Fiscal Strategy of the Government lasted only a few months as the valid framework steering fiscal policies – from December 2020 to April 2021 – only to be abandoned with the adoption of the supplementary budget, which increased the deficit in 2021 from 3% of GDP to almost 7% of GDP. This divergence from the plan can only partly be justified on objective grounds (extended public health crisis), but even that is questionable since in December 2020, when the Strategy and the

Budget for 2021 were being adopted, it was already known that the pandemic would extend into 2021, likely requiring additional state aid packages. An important reason for the quick abandonment of the planned fiscal policy for 2021 lies in the major changes in certain budget appropriations that were not related to the crisis (e.g. in April 2021, budget funds for equipping the military were almost doubled compared to the plan from December 2020). It is exactly this kind of ad-hoc changes in public policies that present a major risk for the achievement of the planned objectives from the new Strategy.

Fiscal objectives from the Draft Strategy are achievable, but their implementation will mainly depend on the Government's commitment to their consistent implementation. The main objectives envisaged in the Strategy are achievable with responsible fiscal policy implementation and do not require strict restrictive measures. Even though the deficit reduction from the planned 7% of GDP in 2021 to 3% of GDP may look drastic at first sight, a major share of this adjustment will be automatically achieved by expiration of anti-crisis measures from 2021, which are, by their nature, one-off measures. The remaining decrease of the deficit from 2022 to 2024 (from 3% to 1% of GDP) is relatively moderate and it is economically justified to achieve it precisely in the manner planned in the Draft Strategy – without increasing taxes or making major cuts to public investments, but with firm control of the largest current budget expenditures (pensions, salaries, subsidies, procurement of goods and services). Such fiscal policies would also be rewarded with a gradual decrease of expenditures on interest (due to the decrease in public debt), which opens additional space to decrease the budget deficit.

In the Fiscal Strategy Draft, the Government reiterates its commitment to the "Swiss formula" for pension increase. Following long and painful restoration of the pension expenditures to a sustainable level, and after a long and wayward search for a sustainable pension indexation model, the pension system was finally brought under control in 2019 and 2020, when the Government started implementing the "Swiss formula" for pension increase. This formula resulted in an increase in pensions by 5.4% in 2020 and 5.9% in 2021. This increase was somewhat larger than the economic growth achieved during the health crisis, as the "Swiss formula" shows a certain delay in keeping up with economic trends – in bad times, it provides for a somewhat faster pace of pension growth compared to economic growth, whereas in good times, this is somewhat slower. The Strategy therefore appropriately forecasts that in the upcoming years, once the health crisis is over, the pension increase will amount to between 5.5 and 6% per year, i.e., that their growth will be somewhat smaller than the forecast growth of GDP. Hence, the share of pensions in GDP will start decreasing again towards the 10% mark after its temporary increase in 2020 and 2021. What is also important is the fact that the Government has confirmed in the Draft Strategy that it is not planning to change the current pension indexation method in the upcoming three-year period. This is especially important bearing in mind that a sustainable pension system is one of the most important pillars underpinning public finance, whereas there have already been some statements in public announcing the change in the "Swiss formula" aimed at a larger increase in pensions. The harmful impact of increasing pensions above their economically objective parameters can best be illustrated with the example of what happened in 2008. Excessive increase of pensions from 2008 has not brought any long-term benefits even to pensioners themselves, as their pensions were increased at a rate slower than the increase of living costs for many years after 2008, and even temporarily decreased from the end of 2014 to November 2018.

The Fiscal Strategy Draft plans public sector salary growth of about 4.5% per year on average over the coming three-year period. Salaries of employees in the public sector were increased in 2020 by over 10%, and in 2021 by over 5%, which is an increase significantly higher than economic growth in the same period. However, the Draft Strategy plans a U-turn in the policy of increasing salaries in the public sector. The Strategy foresees growth of about 4.5% in the upcoming three years, on average, for the salaries of employees in the general government. Such controlled increase of salaries in the public sector would be significantly smaller than their average growth in the previous years, lower than the growth of GDP, as well as lower than the planned growth of pensions. In that case, according to the plan presented in the Strategy, budget expenditures for salaries of general government employees would be significantly decreased when compared to GDP – from 10.4% of GDP in 2021 to 9.7% of GDP in 2024. The envisaged moderate increase of salaries in the public sector is economically justified – and in that regard, there are no objections to the Strategy. The problem, however, is that similar plans were included in every Strategy in the last five years – never to be implemented.

The Revised Strategy should provide a firmer plan for the regulation of the public sector salary and employment system, defining clear and objective criteria for wage increases. Excessive growth of salaries in the public sector is the consequence of a lack of systematic regulation of this part of public finance (such as the system regulating pensions). Due to the lack of regulation in the system of salaries and employment in general government, the annual increase of salaries in the public sector has been reduced to ad-hoc decisions of the Government for many years, instead of relying on objective economic criteria. Regulation of the salary and employment system has been announced as an important element of reform back in 2014; in the meantime, the umbrella law has been adopted, along with a part of the sector legislation, but full implementation of a unique pay grade system and optimisation of the number and structure of employees in the public sector is still lacking. Draft Strategy for 2022-2024 announces the adoption of the remaining sectoral legislation by the end of this year, with a very vague statement that *"the implementation of the new reformed system should start in the post-pandemic period"*. Therefore, once again no concrete deadline is being set for the completion of this reform, while numerous important issues still remain open: nothing is said about the base pay, there's no information on when the job positions will be completely evaluated (and when the results will be published), there's no mention of when the legislation regulating wages of public officials will be adopted, whether the new system of unique pay grades will also include the military and the police, equally treated with the rest of the public sector (e.g., single salary base) as initially planned etc. Finally, the introduction of the central register of employees has been announced for 2023, despite the fact that as far back as in 2015, the Fiscal Strategy emphasized that the process of introducing the central register of employees "was almost completed". Hence, the Revised Fiscal Strategy for 2022 should include significantly more detail on the schedule and deadlines of the most important elements for the reform of the salary and employment system in the public sector. At that, the Revised Strategy should clearly define the principles and limitations to the increase of salaries in the public sector. The current definition of their increase from the Draft Strategy, stating that "*salaries shall be increased moderately and in a controlled manner, taking care of their share in the GDP*" is insufficiently precise and therefore not credible.

The subsidies are planned to be reduced to the historical low of 2% of GDP in 2024 – but there is no concrete reform plan of the largest public and state-owned enterprises. Budget expenditures for subsidies (including budget loans and the payment of guaranteed debt) amounted to 3.5% of GDP on average, per year, in the period 2005-2020, which is almost triple that in the CEE countries. At that, these expenditures never went below 2.6% of GDP in the observed period. The main reason for such high subsidies in Serbia lies in poor performance of public and state-owned enterprise – every year, some failing public or state-owned enterprise shows up needing government rescue. In 2021, Air Serbia is the planned recipient of budget funds. In 2020, it was Air Serbia and EPS, and before them, Srbijagas and Petrohemija, while Železnice and Resavica are regular beneficiaries of government subsidies. According to the plan in the Draft Strategy, these should fall below 2% of GDP in 2024, which would be a historical success – it would be the lowest level of expenditures for subsidies from the budget in the recorded history of fiscal data for Serbia. The issue, however, is how realistic these economically sound plans are. For this reason, the Revised Fiscal Strategy should define, in more detail, the deadlines and planned steps in the reform of the most prominent public and state-owned enterprises.

Draft Strategy envisages exceptionally high public investments in the upcoming three years, of about 6.5% of GDP per year – which the Fiscal Council conditionally supports. In absolute numbers, this plan would encompass investments of the government of over 11 bn Euros in the period of 2022-2024. If we include 2021, this would add up to about 15 bn Euros. The sharp rise in public investments was one of the main Fiscal Council's public finance management recommendations for years. This recommendation was based on the need to improve the poor quality of infrastructure, the quality of life of Serbian citizens and encourage economic growth. From that point of view, the proposed medium-term level of public investment represents a good framework for the achievement of these goals. However, the details of the investment plan (priority, sectoral structure, project list) are not elaborated in sufficient detail, raising many questions. For example, it is unknown to what extent the planned public investments would rest on the investments in the security sector (where investments in the previous years were exceptionally high). These investments don't have a significant impact on the acceleration of economic growth and they have no effect on the improvement of the country's basic infrastructure. On the other hand, it is possible that the government will redirect its focus to the so-called Green Agenda and strongly increase investments into the development of the neglected communal infrastructure and mitigation of pollution. This is important, primarily, from the viewpoint of the health of the population, but it would also be beneficial for economic growth and for Serbia's obligations in the process of EU accession. The matter of project selection and prioritization is gaining importance as extremely high public investments are planned for the upcoming years, while at the same time the construction of the major undisputed projects (major roads and railroads) is coming to an end. The Fiscal Strategy, however, does not offer clearly defined levels of investment by sectors, supported by a concrete project list, or a methodologically substantiated explanation on why the particular strategic priorities and concrete projects have been selected. Without such information, it is impossible to have an objective view of the government's public investment policy – so we expect that this part will be improved when the Revised Fiscal Strategy is elaborated.

More attention should be paid to the risk of increasing expenditures for penalties. The government's expenditures on penalties, fines etc. represent a growing risk for public finance. In the period from 2009 to present, the Republic of Serbia has paid over 120 bn dinars, i.e., over 1 bn Euros, for fines and penalties. At that, these expenditures show a relatively steep growing trend over the years. Payments on these grounds amounted to 4 bn dinars at the end of 2010, only to grow to over 20 bn dinars in 2020, threatening to continue this growing trend in the future. Although this issue could mean major expenditures from the budget in the medium term, the Fiscal Strategy does not address it properly. Namely, the Strategy plans for a decrease in "other current expenditures" in the medium term (which is where fines and penalties are classified), which could easily turn out to be an overly optimistic forecast. State Audit Institution (SAI), in its Report on the Statement of Final Accounts for 2019 published a spreadsheet of potential liabilities, on the grounds of 7,764 court cases in the competence of 11 Ministries, the value of which, at the end of 2019, amounted to at least 59 bn dinars (500 m Euros). Although the report does not state this explicitly, it can be derived that these are court cases under domestic jurisdictions (not international), meaning that the total potential liabilities could very well turn out to be drastically higher than the records show. Bearing in mind the magnitude of this issue and the fact that some institutions (SAI) have at their disposal detailed data and publish a review of budget liabilities arising from court cases – we believe that there is no obstacle to having similar, and broader spreadsheets appearing in Fiscal Strategy and including them in fiscal projections.

Macroeconomic forecasts in the Fiscal Strategy are generally adequate. The Fiscal Strategy forecasts a GDP growth of 6% in 2021, followed by a deceleration of economic growth to 4% in 2022 to 2024. In the medium term, the inflation is forecast as relatively stable, at about 2.8% per year, while the current balance-of-payments deficit is forecast at about 5% of GDP with a gradually decreasing trend. At the time of increased insecurity brought about by the health crisis, changes of macroeconomic aggregates can be abrupt and difficult to predict (e.g., the most recent acceleration of the global inflation) – making it more difficult to come up with macroeconomic forecasts. Although certain changes in the macroeconomic aggregates are possible until the end of the year, when more data will be available on the course of the pandemic and the economic recovery, we see the forecasts used to elaborate the Fiscal Strategy as suitable, at this time. GDP growth of 6% in 2021 seems realistic from the current standpoint, following the adoption of the supplementary budget that has increased, quite significantly, the investments into infrastructure, but also because of the positive economic trends in Q1 2021. Restoration of the GDP growth rate to 4% in the medium term is similar to the growth trend that Serbia had prior to the health crisis, meaning that this medium-term forecast is satisfactory, for the time being. A pronounced inflation increase compared to the previous Strategy is in line with the latest available data, while the GDP deflator is not significantly different from the forecast inflation, which is also appropriately planned. Trends in foreign trade shall depend, to a large extent, on the prices of the most important exported and imported products in Serbia, which is difficult to predict at the moment – but the Fiscal Council currently has no significant objections to these forecasts, either.

Table: Key recommendations for improvement of the revised Fiscal strategy for 2022-2024

Issue	Current treatment in the Draft	Recommendations for improvement in the Revised Fiscal Strategy
Mid-term projections of expenditures for employees doesn't include effects of planned pay grade reform	Nothing is said about key parameters of new pay grade system, which should already be known (because it is announced that the rest of sectoral regulation will be adopted until the end of 2021)	Declare basic elements of the new unique pay grade system in public sector (scope, level of base pay, range of coefficents and wages, etc)
	No deadlines for the implementation of the new system (term "in post-pandemic period" is very broad)	Set firm deadlines for: 1) complete adoption of the rest of sectoral regulations, and 2) start of full implementation of the new system
It is not possible to assess how realistic are the projections of public investment and how effective would they be	Investment priorities are not set, nor is the aimed sectoral structure (transportation, environtment, defence, health, education)	Clearly set priorities of government's investment policy and define aimed sectoral levels
		Present investment plan "Serbia 2025" and connect it with mid-term projections of capital expenditures
Some fiscal risks that can already be quantified are neglected	Potential expenditures for penalties and fines (after court decisions) are not included in the mid-term fiscal framework	Include all lost court cases that are already known into the fiscal risks
		Make projections of potential expenditures and allocate in forthcoming years (some data already exist - SAI for 2019)
The plan for improvement in the structure of subsidies is not sufficently credible	No firm reform plans for SOEs which undermines the credibility of the projected reduction in subsidies until 2024	Show sectoral structure of subsidies (including local government)
		Explicity set deadlines and undisclose all planned reform tasks for the most important SOEs (EPS, Srbijagas, railways), local public enterprises and companies in the process of privatization