Republic of Serbia
FISCAL COUNCIL
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Assessment of the proposed Budget Law of the Republic of Serbia for 2022

Summary:

The proposed budget has been planned rather cautiously, suggesting that the 2022 fiscal trends may be better than projected. The proposed Budget for 2022 continues with a gradual fiscal deficit decrease compared to previous years. The planned fiscal deficit for 2022 amounts to approximately 1.7 bn Euros (3% of GDP), which is lower than the deficit of 2020 (3.8 bn Euros) and planned deficit of 2021 (2.6 bn Euros). At that, the envisaged 2022 fiscal deficit leads to a minor decrease of the excessive public debt to GDP ratio (planned to decrease from 58.2% at the end of 2021 to 56.5% at the end of 2022). Although a 3% of GDP deficit in 2022 undoubtedly represents a step in the right direction, it is still too high and unsustainable in the long-term, so it will have to be decreased in the upcoming years (as the Fiscal Strategy envisages). However, the Fiscal Council already sees as highly likely that public revenues in 2022 could be significantly higher than planned (especially taking into consideration the recent inflation surge), while public expenditures have been planned too wide and the execution could easily be below the planned amount. Such trends would lead to an even more favourable, lower fiscal deficit than the planned 3% of GDP in 2022. The Fiscal Council recommends that these potentially better fiscal trends should be used to reduce the fiscal deficit to about 1 bn Euros already in 2022 (below 2% of GDP) – instead of introducing new, currently unplanned expenditures in the budget (which was a common practice in similar situations in the previous years). Public finance could, thus, be steered towards relatively calmer waters already in 2022, with minimal effort – which is an opportunity that should not be missed.

The most important individual budget elements have been defined, for the most part, with adequate fiscal responsibility and economic justification. A more detailed look into the proposed budget shows that quantitative targets have been adequately planned for the majority of the most important items in the budget. Pensions and salaries in the public sector, which are by far the largest budget expenditure, remained under control. An increase of pensions of 5.5% has been defined by the objective "Swiss" formula, which is generally economically adequate (although there is still room to improve certain elements of this formula in 2022). The envisaged growth of salaries in the public sector, which on average amounts to 7.3%, is in line with the expected economic growth and is thus sustainable from the budgeting perspective; unfortunately, however, it remains the result of discretionary decisions of the Government and not of a systemic framework for public sector salaries (like the one that is used for pension indexation). The general government investment in infrastructure in 2022 have been preserved at a desired, very high level. At that, it

should also be noted that the good practice of gradual fiscal relaxation of the tax burden on salaries is also continued in 2022 (the pension contribution is planned to be decreased by 0.5 pp).

However, the budget suffers from certain qualitative weaknesses that are mostly repeated from previous years. Along with the positive elements, the proposed 2022 budget still has certain weaknesses that the Fiscal Council has been emphasizing in the previous years. One recurrent issue is the lack of transparency pertaining, first of all, to the expenditures of the Public Investment Management Office, certain parts of subsidies, net budget loans and the security sector. Another issue that remains disputed is the ad-hoc principle of determining the overall increase of the salaries in the general government, with different raises in different sectors; in addition, the budget ignores the issue of a shortage of employees in certain parts of the general government. One part of the social policy is still managed through economically inefficient and non-selective payments to all pensioners (the planned payment of 20,000 dinars to each pensioner), without considering their economic status nor the fact that financial assistance might be more needed elsewhere, in some other socially more vulnerable groups. It is unclear how the public investment projects in 2022, which are quite generous, have been prioritized. Energy crisis as a possible source of fiscal costs is completely overlooked in the proposal, and we see certain ad-hoc modifications to the tax policy which diverge from good practice, etc.

The fiscal trends of 2021 will probably be somewhat better than expected, leading to a lower fiscal deficit in 2022 compared to the proposed budget plan. Execution of the 2021 budget serves as the foundation for the elaboration of the 2022 budget. In simple terms, public revenue and public expenditure forecasts in 2022 are determined by adding the forecast of macroeconomic trends and economic policies planned for 2022 on the execution of the 2021 budget. If the fiscal trends of 2021 come in better than expected, that will be carried over to a smaller deficit in 2022 – and our analyses indicate that this may very well be the case. In the recently adopted second supplementary budget for 2021 (from October), the fiscal deficit was planned at 4.9% of GDP in 2021 (about 2.6 bn Euros). However, a more detailed analysis of the public revenue and expenditure, as well as of the latest available fiscal and macroeconomic data, indicates that the budget deficit in 2021 could be about 500 m Euros lower than planned, i.e., about 4% of GDP (2.1 bn Euros). In addition, a sizable share of the 2021 fiscal deficit is made out of one-off anti-crisis measures that will be exhausted by the end of 2021 and will no longer be a burden on the budget in 2022. About 3.5% of GDP of the currently expected deficit of 4% of GDP is based upon extraordinary anti-crisis measures, meaning that we are entering 2022 with public finances that are almost completely balanced. This indicates that the fiscal deficit of 3% of GDP in 2022 has been planned too broadly and that the actual fiscal result will probably be better than planned.

Average inflation in 2022 will be significantly higher than the budget assumes, which will lead to increase in public revenues compared to the plan. Since August 2021, there has been a relatively steep inflation acceleration, which then extended into September and October. Due to this acceleration, the year-on-year growth of consumer prices reached 6.6% in October, which is far higher than what the relevant institutions expected just a few months ago. Since the price growth accelerated relatively quickly and unexpectedly, this has not been fully implemented in the budget forecasts for 2022 (or in the supplementary budget from October 2021). It is likely that the average price increase in 2022 will amount to about 5%, while the budget has been elaborated with the assumption that the average price growth will be 3.7%. Higher-than-expected inflation will have an impact on public revenue increase compared to the plan, while it should have no significant impact on public expenditure. Although inflation analysis falls outside of the Fiscal

Council's competencies, for the time being and with reserves, we assess that the latest price increase mostly came from the international market and that it will, most likely, be temporary – having also in mind that the so-called core inflation (with energy, food, alcohol, and cigarettes excluded) is still relatively low, under 3%. An economic policy that would help slow down inflation is one of balancing public finance, which is another argument in favour of additionally decreasing the fiscal deficit in 2022.

In 2022, public revenue will probably be significantly higher than planned, but the Fiscal Council welcomes the increased caution in its planning. The proposed budget for 2022 plans the public revenue unusually cautiously (even with the old, lower inflation forecasts). Forecast of the budget revenue growth from VAT in 2022, compared to 2021, of 4.6% illustrates this point. This would be quite a conservative forecast even with an average inflation in 2022 of 3.7%, which was used during the budgeting process, as private consumption is expected to grow by over 3.5% in 2022. Since the average inflation in 2022 will most likely amount to about 5%, the forecast growth of VAT revenue of 4.6% now looks even more conservative (it's even somewhat lower than the expected price growth, which is very unlikely). Similar, more conservative forecasts are presented in the budget for all other public revenues as well. However, the Fiscal Council does not find that the highly cautious public revenue planning in 2022 was wrong. On the contrary, numerous uncertainties related to the future course of the pandemic and the economic trends call for increased caution. Therefore, although it currently seems almost definite that the public revenue might be significantly higher than the budget plan, at turbulent fiscal times, good budgeting policy calls for far more cautious public revenue planning than usual.

Relatively large savings on public expenditures, in the order of magnitude of about 400 m Euros, are very likely. Unlike public revenue where the quite probable better-than-planned fiscal trends can still not be quantified precisely, with public expenditure it is possible to perform somewhat more concrete quantitative analyses. The Fiscal Council's analysis shows that in 2022, there will be probable savings in terms of budget expenditures for pensions, subsidies, procurement of goods and services and transfers to the National Health Insurance Fund (NHIF) in the total amount of almost 400 m Euros (about 0.7% of GDP).

Pensions. Expenditures on pensions have been increased by 5.5% in 2022, in line with pension indexation according to the "Swiss formula" (with an additional increase in transfers to the Pension Insurance Fund (PIF), from the national budget, to cover the one-off financial assistance of 20,000 dinars to all pensioners). However, when the budget was being prepared, it was assumed that the number of pensioners will remain the same in 2022 as it was in 2021, which will almost certainly not be the case. The latest data from August 2021 indicate that the number of pensioners in Serbia is currently declining by about 1.5% annually, and this trend cannot be suddenly overturned in 2022. Due to the declining number of pensioners (that the budget has overlooked), we expect expenditures on pensions in 2022 to be about 80 m Euros lower than those planned in the budget.

Subsidies for anti-crisis guarantee scheme. As a part of the anti-crisis package for businesses in 2020 and 2021, the government issued guarantees for bank loans to be taken out by the private sector. The cost that the budget will incur due to this is, by definition, uncertain, i.e., it is difficult to forecast reliably. Namely, as long as a privately owned enterprise is repaying its loans in time, there is no expenditure for the government. However, if the enterprise is unable to repay its loan to the bank, the government, being the guarantor, must cover the part of the debt that is still outstanding from the budget. In 2021, budget expenditures for anti-crisis guarantees amounted to about 10 m Euros, indicating that most of the private sector are properly paying off their loans to the banks (over 2 bn Euros in loans were approved through this scheme). However, despite the currently low budget expenditure levels for "anti-crisis" guarantees, the 2022 budget envisages about 100 m Euros for these purposes, which is ten times higher than in 2021. Although cautious planning is generally a good approach, we nevertheless believe that the reserved amount is too high and that the government expenditure on these grounds will probably come 50-80 m Euros lower than budgeted.

Procurement of goods and services. The budget plan for the procurement of goods and services has been set at quite a high level and we expect savings of at least 80 m Euros on these grounds. The excessive budgeting of expenditures for the procurement of goods and services stems from the supplementary budget for 2021 (used as the foundation for the elaboration of the 2022 budget). Judging from all available data, expenditures for goods and services will already show a significantly lower execution than planned in 2021. Since we assess this reduction from 2021 as structural, i.e., more durable, we expect it to reflect on lower expenditures for goods and services in 2022 as well.

Transfers to the NHIF. Similar to 2021, in 2022 these transfers have been planned at about 300 m Euros higher than their usual, pre-crisis level. This means that there is a relatively large reserve and an open budget line in case the Coronavirus pandemic flares up again in 2022. Fiscal Council sees this as both justified and commendable, as the possible worst-case scenario for the health crisis in 2022 cannot yet be fully excluded. Still, it is very likely that there will be no need to use such vast funds. In 2022, the healthcare system will certainly experience some irregular expenditures, but we estimate that maybe a half (about 150 m Euros) of the planned transfers to the NHIF will not be utilized.

The budget has failed to properly recognize some serious fiscal risks, which may require unordinary fiscal interventions. An important shortcoming in the 2022 budget is that it fails to envisage any solution (or budget funds) for the issues Serbia will face due to the current energy crisis. Due to the rise in procurement price of gas, it is almost certain that Srbijagas will face some issues in its operation that may directly or indirectly require budget funds to resolve. In the conditions of increased gas prices, the market mechanism that would protect Srbijagas from losses would dictate that the gas tariff be proportionally increased, and it would assume perfect collection of payments. However, it was already announced that the price of gas for households (and guaranteed suppliers) will not be changed, which leads Srbijagas into losses. At that, the question of the collection on the more expensive gas tariffs delivered to city heating plants is still open, while it is almost certain that the enterprises that were unable to pay for the current, lower gas tariffs (such as MSK from Kikinda) will not be able to afford the increased price. We estimate that Srbijagas's losses due to increased purchase price of gas could amount to at least 100 m Euros. In addition to the possible expenditures caused by the energy crisis, the budget also does not plan for any anti-crisis measures to support the economy. This assistance, however, would have to be relatively minor in terms of the budget balance, since only small and specific segments of the economy are still affected by the epidemiological measures (e.g., hospitality sector). A possible fiscal risk could also come from Air Serbia, which received budget funds already in 2020 and 2021. However, the budget line used to pay out the funds transferred to this company is not transparent, so it is unknown whether this company represents a fiscal risk, or if the Government has already planned some expenditures for Air Serbia in 2022.

The expected, and more favourable, fiscal trends should, however, make enough room in the budget to cover any unforeseen expenditures. We estimate that the aforementioned fiscal risks could present an one-off cost for the budget in the total amount of about 200 m Euros in 2022. These are significant funds, but they should not greatly affect the main fiscal trends in 2022. Namely, one specific trait of the 2022 budget is that, on the public expenditure side alone, we already see a possibility of savings that exceed the observed fiscal risks by two-fold; in addition, public revenue will probably come in significantly higher than planned in 2022. Therefore, when all things are considered, the Fiscal Council's assessment is that fiscal trends in 2022 should move in the direction of a smaller budget deficit than the planned 3% of GDP – even if some unplanned, unordinary budget expenditures pop up.

The "Swiss" formula has transpired to be a superior method for pension indexation during the health crisis, but there may be room for some small improvements. In 2021 and 2022, the pensions were cumulatively increased by 11.6% (in real terms, 5.6%) based on the "Swiss" formula. This is a sustainable and objective pension increase that approximately matches the realized cumulative economic growth rate in the same period. In 2022, however, the "Swiss" formula calls for a pension increase of 5.5%, which is somewhat lower than the expected nominal GDP growth. The reason why the pension increase will lag behind the economic growth in 2022 lies in the fact that the calculation of the "Swiss" formula is performed in June and the relatively strong inflation increase started taking place from August. In the long-term, however, this will not be to the detriment of the pensioners, as the latest inflation acceleration will be included in the 2023 pension indexation, which could easily amount to 8% (meaning that pension growth in 2023 will probably be somewhat steeper than the economic growth). Still, perhaps it could be considered if there are technical possibilities to index pensions in a more promptly manner. The other important event that the "Swiss" formula was unable to capture is the extraordinary decrease in the number of pensioners during 2020 and 2021. The number of pensioners will most likely be 3% lower in 2022 than in 2019, which will lead to a proportionate decrease in the pension bill. All things considered; we see a certain economic argument in favour of a minor modification of the "Swiss" formula. The most important thing, however, is that this process should be approached with great caution (if at all). Pensions are the most sensitive public finance segment and any change in their current indexation (which is indisputably good) would have to follow after a comprehensive and careful analysis.

Increase of salaries in the general government in 2022 is appropriate, in principle, but the system of regulating public sector employment and salaries has remained quite chaotic. Unlike pensions, indexation of the salaries in the public sector has not been defined in a systematic and economically objective manner. Hence, their increase is defined every year based on discretionary decisions of the Government – which is often problematic. Immediately before the budget was finalized, in October 2021, the Fiscal Council recommended to the Government that the budget expenditures for employees in 2022 be increased by about 7% – which would include a salary growth of about 6% and an increase in employment by 1%.[1] The proposed budget also calls for an increase in public expenditures for salaries of 7%, but based on different parameters that are, as we see it, of lower quality. Namely, the following are planned: 1) increase of the salaries in the general government of 7.3% on average (salary raise for the defence, healthcare and social protection sector of 8% and for all other employees, of 7%) and 2) keeping the number of public sector employees at the same level in 2022 (despite the fact that some important sectors remain largely understaffed). Since there will be a considerable tax relaxation of salaries in 2022 (decreased rate for pension contributions), the total wage bill in 2022 will grow by less than 7.3%,

[1] See the Fiscal Council report: "Assessment of the Proposed Supplementary Budget for 2021 and basic recommendations for the 2022 Budget" from October 2021.

meaning that it will be increased by exactly the rate the Fiscal Council suggested – about 7%. The second important recommendation that the Fiscal Council made to the Government was that in 2022, it should finally start resolving the major structural issues with the salary and employment system in the public sector, in small, but realistic steps. However, in this respect, the budget brings no improvement, even though the reform of the salary and employment system has formally been on the Government's agenda for almost a decade.

The government's expenditures for public investments remained at an economically favourable, high level in 2022. Expenditures for public investments cannot be seen directly in the state budget as some of them are implemented via public enterprises (Putevi Srbije, Koridori), mandatory social insurance organisations, indirect budget beneficiaries or are implemented by local governments. An analysis at the level of consolidated, general government shows that, in 2022, approximately 4.1 bn Euros will be allocated to public investments (7.3% of GDP). Although at first glance it seems that there has been a decrease in public investments compared to 2021, when they amounted to 7.8% of GDP, this difference comes from the fact that there has been a slight decrease in the record-breaking investments into the security sector from 2021 (however, despite this decrease, these investments are still quite high in 2022). Public investments, excluding defence and police, will be at the level of about 6.3% of GDP in 2022, which is identical to the level from 2021 and, in our view, appropriate for Serbia.

The system of selecting and monitoring infrastructural projects in Serbia has not been regulated properly. Up until a few years ago, the matter of selecting investment projects was not as important as it is today – since relatively little money was being set aside for public investments, barely sufficient for the construction of the country's most important corridors. However, since the public investments allocations have been increased manifold compared to 2017, and some of the direct investment priorities have been completed – a good project selection becomes one of the key issues of public finance. To illustrate this point, we can see that relatively large funds have been set aside for the construction of the National Stadium in 2022, despite its profitability not being demonstrated in public. At the same time, public investments into healthcare and education have been decreased in 2022 compared to 2021, while investments into communal infrastructure and environment protection have only been increased marginally. There is no publicly available document that would show why it would be of national interest to build a National Stadium in 2022, instead of investing more into important fields that were neglected for many years. In addition, there is a profound non-transparency in implementing certain infrastructural projects, especially those executed through the Public Investment Management Office. Not only is there no clear definition of which investments shall be implemented through PIMO, but even after their completion, the records on these projects are not published in a systematized, clear manner. An important reason for the disordered state of the current system for selecting and improving public investments lies in the inadequate legislation in this field. Although the cost-benefit analysis of the investment projects exceeding 5 m Euros is formally mandatory prior to initiating project implementation, numerous exceptions from this procedure have been envisaged (projects of national importance, line projects, investments into the security sector). In addition, the Government is not obliged to publish cost-benefit analyses even for those projects that require such analyses – which makes the entire process moot.

Once again, in 2022 social policy is partly implemented through non-selective hand-outs to large population groups – which is a practice that needs to stop. In the previous years, the Fiscal Council analysed non-selective payments of identical amounts to all citizens of age, or to all pensioners, on several occasions. All these analyses have shown that this is not a good practice and that it would have to be permanently abandoned. However, the 2022 budget again calls for the payment of a one-time assistance in the amount of 20,000 dinars to all pensioners, regardless of their material status. This will cost the 2022 budget almost 300 m Euros. Instead of such payments, a truly efficient and fiscally responsible social policy would require that the financial aid be paid out only to the socially vulnerable population. At the start of 2020, the Government adopted the umbrella Law on Social Card that envisaged that all relevant data on the material status of Serbian citizens would be collected in one place. Article 24 of this Law prescribes that the system of social cards shall start to apply for the social aid expenditures from March 2022. However, the 2022 budget brings no notable change in expenditures for social protection that would imply that such a fundamental change is about to take place in 2022, and this legally prescribed reform contains no relevant information in the appendices to the budget, either. That means that the legally prescribed deadlines for the implementation of this very important reform will probably be breached.

The proposed budget is most likely temporary, as parliamentary elections approach in 2022, which are – as a rule – followed by a supplementary budget. The specific property of the proposed budget is the fact that it probably will not last throughout the year. Parliamentary elections are planned for the spring 2022, after which a new Government will be formed; this practice also usually includes the preparation of a supplementary budget. From the viewpoint of public finance, the new Government will have two important tasks. The first, somewhat easier, is to continue leading a responsible fiscal policy and balancing the budget, which could be implemented already in 2022, for the most part. The second, more challenging task that the new Government will face is the reform of important public finance segments – first, the salary and employment system in the public sector, the welfare system, tax system, public investments implementation procedure, increase the transparency of the budget and public policies, etc.