Republic of Serbia
Fiscal Council

OPINION ON THE REVISED FISCAL STRATEGY FOR 2022 WITH FORECASTS FOR 2023 AND 2024

Summary:

Revised Fiscal Strategy preserves the generally well-planned fiscal policy objectives – gradual decrease of deficit and general government debt. The main quantitative objectives of the Revised Strategy have remained unchanged compared to its Draft from May 2021. The fiscal deficit should first be decreased to 3% of GDP in 2022, continuing the declining trend to 1% of GDP in 2024. The objective for public debt also remains, calling for its share in GDP to be decreased by about 4.5 p.p. compared to the end of 2021 – from 58.2% of GDP to 53.8% of GDP.[1] In its Opinion on the Draft Strategy from June 2021, Fiscal Council already assessed this plan as acceptable, and we stand by this assessment in our Opinion on the Revised Fiscal Strategy. Firstly, Serbia's incontestable public finance priority is to decrease the fiscal deficit and public debt, which is why the Fiscal Council supports this fiscal policy trend in the medium term. Secondly, it is also good that the Strategy calls for medium-term adjustment of the fiscal deficit in an economically sound way. The foundation for gradual fiscal deficit decrease in the medium term should be a reduction in current budget expenditures, while maintaining the high share of public investments in GDP and without increasing tax rates (actually, the Strategy calls for a gradual tax relaxation for the business sector once the conditions are met).

However, a chance has been missed to put the more favourable fiscal results from 2021 to even better use – which would lead to a decrease of the government debt in the medium term by over a billion Euros. When the first Fiscal Strategy Draft was elaborated in mid-2021, it was planned that the government deficit in 2021 would reach almost 7% of GDP, and then be gradually decreased – first to 3% of GDP in 2022, then falling somewhat slower in the upcoming years. In the meantime, however, there has been a significant shift in fiscal trends. Labour market performance in 2021 exceeded expectations, and the inflation and economic growth both came in higher than forecast. This had a major impact on improved public revenue collection

[1] The only difference compared to the Draft is that the document from May plans for a public debt reduction from 60% of GDP at the end of 2021 to 55.5% of GDP at the end of 2024. Since a smaller deficit will be achieved in 2021, i.e., the government will borrow less compared to the forecasts from May, the starting point for the public debt decrease (end of 2021) has been corrected accordingly, to a lower level of 58.2% of GDP in the revised Strategy.

compared to the plan, leading to a lower fiscal deficit of 4.9% of GDP in 2021 (and it is quite likely that the 2021 deficit will come in at an even lower level). The Fiscal Council's position is that these unplanned fiscal improvements of 2021 should have been used for a more ambitious deficit decrease in the medium term (specifically, setting the deficit path for the 2022-2024 period to: 2% → 1% → 0.5% of GDP, instead of 3% → 1,5% → 1% of GDP). Had the deficit decrease in the medium term been planned more ambitiously, Serbian public debt would be by over one billion Euros lower at the end of 2024, compared to the plan from the Revised Strategy, which is a major difference.

The Government will probably have a new chance to adopt a plan of a somewhat steeper deficit and public debt decrease compared to the Strategy during 2022. A somewhat more restrictive general government deficit, compared to the plan from the revised Strategy, is not only economically justified, but also achievable without major sacrifices. Although the fiscal deficit in 2021 is incontestably high, its largest share, i.e., almost 3.5% of GDP of the planned 4.9% of GDP is allocated to one-off measures that are not a permanent budget expenditure (payment of minimum wages to private companies, non-selective financial assistance for citizens etc). That means that a fiscal deficit close to 1% of GDP is taken over into 2022, and there is no reason why such a deficit would be significantly increased in 2022, only to be reduced thereafter. Even the Strategy itself points out the unnatural trajectory of fiscal deficit in 2022, since Table 21 (page 70) in the Revised Strategy shows a calculation of the structural (permanent) deficit in 2021, which amounts to a mere 0.7% of GDP. It is possible, however, that the Government is still cautious with the attained savings and fiscal improvements of 2021 and that it has opted not to fully include them in the plan for the upcoming years. In that case, it would be good to lower the deficit in 2022 in the first upcoming supplementary budget (which will follow after the announced Parliamentary elections and the formation of the new Government), and then to transfer the decrease in the plans for the years to follow.

Main Fiscal Council recommendations for the improvement of the previous Draft Fiscal Strategy pertained to the increase of its credibility. In its opinion on the Draft Fiscal Strategy for 2022 with forecasts for 2023 and 2024, dated June 2021, the Fiscal Council presented several recommendations aimed at improving the credibility of this document. According to the Budget System Law, the Government should adopt the Fiscal Council recommendations in the final Fiscal Strategy (or explain why it has opted not to adopt certain recommendations). These recommendations are shown below in Table 1.

Table 1 Review of the main recommendations for the improvement of the Draft Fiscal Strategy for 2022, with forecasts for 2023 and 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

Source: Fiscal Council: "Opinion on the Fiscal Strategy for 2022 with forecasts for 2023 and 2024"

Some of Fiscal Council's recommendations, however, have not been included in the revised Fiscal Strategy and some have not been adopted in the appropriate way. It is unquestionable that the Revised Fiscal Strategy brings many technical and material improvements that the Fiscal Council welcomes (more substantiated macroeconomic analyses, analyses of short-term fiscal sustainability with a comparative analysis, presentation of the implementation of the anti-crisis package and assistance to both the economy and the population, by individual measures, etc.) However, when it comes to concrete Fiscal Council recommendations, provided in answer to the Draft Fiscal Strategy from May, they have only partly been introduced into the Revised Fiscal Strategy.

- *Salary system reform*. After far too many delays, the implementation of the new, reformed salary system for general government has been moved, in the revised Fiscal Strategy, to 2025 – beyond time frame covered by the Strategy without any specific details on the matter. On one hand, the Government now finally openly admits the failure of the current approach in the implementation of this important reform and breaks the cycle of non-credible promises of having the new system come into force in a year or two, then delaying it when the deadline approaches. On the other hand, numerous problems of the existing salary system for general government employees will remain unresolved, and there is no justification for waiting to start resolving them as late as in 2025. The Fiscal Council, thus, recommends that, in 2022, the Government focus only on the burning issues, that can be resolved in the short-term, instead of a comprehensive reform. Significant improvements to the general government salary system could be made by implementing a few fundamental, but realistic steps: 1) linking the total annual growth of salaries in the public sector to economically objective parameters (similar to current pension indexation); 2) introducing a public register of employees and salaries; 3) evening out salaries of employees employed in generic positions at the general government level.

- *Unclear strategic public investments priorities* The Revised Fiscal Strategy brings no improvements in this field. The strategic direction of public investment is still unclear, as well as which analyses were used for the selection of priorities, how much of these total expenditures and capital expenditures will be rerouted to infrastructural projects and how much on equipping the military and the police, etc. Hence, we invite the Government, one more time, to clearly show its priorities in its official documents, as well as projects planned within public investments in the upcoming 3 years.
- *Neglect of certain fiscal risks, especially fines and penalties*. The Revised Fiscal Strategy has made certain improvements in this field. More specifically, the elaboration of a single methodology for monitoring and quantification of fiscal risks, which encompasses its most significant sources (including fines and penalties). The Strategy lists that all planned methodologies should be completed by the end of 2021, which generally conforms to the Fiscal Council's recommendation.
- *Insufficiently substantiated plan for structural improvement in expenditures on subsidies*. The revised Fiscal Strategy generally repeats the allegations from the previous versions of this document, without any concrete steps in the direction of increasing the credibility of the plan for the reduction and structure improvement of state subsidies in the medium term.