Republic of Serbia
Fiscal Council

Assessment of the Proposed Supplementary Budget for 2021 and basic recommendations for the 2022 Budget

Summary:

The proposed supplementary budget is aimed at stabilizing public finance, which can be assessed as favourable (with certain objections). Since the public health crisis broke out in 2020, Serbian public finance has been forced to quickly adjust to the situation as it unfolded, resulting in higher one-off expenditures. This resulted in an unusually high number of amendments (supplementary budgets), all of which included a stark increase of the fiscal deficit (April and November 2020, April 2021). The proposed second supplementary budget for 2021, however, differs from the previous crisis-oriented supplementary budgets in the fact that it proposes a significant fiscal deficit decrease of about 900 m Euros (from 6.7% of GDP to 4.9% of GDP). Although a fiscal deficit of 4.9% of GDP is still too high, it represents a good foundation for the much-needed further public finance stabilisation in the upcoming years. The largest share, i.e., almost 3.5% of GDP of the planned 4.9% of GDP is allocated to one-off measures that do not represent a permanent budget expenditure (payment of minimum wages to private companies, non-selective financial assistance for citizens etc). That means that, going into the next year, we would be carrying over a fiscal deficit that is lower than 1.5% of GDP, which serves as a good foundation for the preparation of the 2022 budget. Therefore, in addition to this assessment of the Proposed Supplementary Budget, the Fiscal Council would like to recommend to the Government to use the favourable fiscal trends of 2021 and plan the 2022 government deficit at the level of 2%, instead of 3% of GDP, as was previously envisaged in the Fiscal Strategy. A somewhat steeper decrease of the fiscal deficit in 2022 than originally planned would have multiple benefits.

Macroeconomic trends in 2021 had a favourable impact on public finance and this "gift" was rightly used to decrease the deficit and increase public investments. Macroeconomic trends in Serbia in 2021, as well as in most European countries, were characterized by a quicker-than-expected recovery and a strong inflation acceleration. The growth of GDP in Serbia in 2021 will probably be close to 7%, which exceeds the forecast used in the original budget (6%) and the last Fiscal Council forecast (5.5%). With increased economic activity, the growth of salaries and registered employment in 2021 also surpassed expectations. However, in addition to the favourable macroeconomic trends, the inflation also accelerated significantly, reaching 5.7% on a year-on-year basis already in September. All these macroeconomic trends taken together had a relatively strong effect on the increase of budget revenues and dictated, to a considerable extent, the proposed supplementary budget. Unforeseen additional funds that were collected in the budget were partly used to decrease the fiscal deficit, and partly to increase public expenditures. More than a half of this amount was allocated to the increase of government

investments into infrastructure and healthcare. Although the proposed supplementary budget has certain weaknesses, we see such an adjustment of fiscal policies to the changed macroeconomic circumstances of 2021 as generally justified.

The envisaged fiscal deficit decrease of about 900 m Euros is the consequence of public revenue growth of 1.7 bn Euros with an increase of public expenditures by about 800 m Euros. Compared to the first supplementary budget from April, the proposed new supplementary budget calls for an increase of national revenues by about 1.1 bn Euros (2.2% of GDP) and a relatively small net expenditure increase of about 200 m Euros (0.4% of GDP) – leading to a decrease in the fiscal deficit of about 900 m Euros (1.8% of GDP). This data from the supplementary budget, however, only shows a part of changes in the budget that actually took place. Namely, the overall general government public revenue increase is much higher than the 1.1 bn Euros shown directly in the national budget, amounting to almost 1.7 bn Euros (3.2% of GDP). The main reason lies in the sharp rise in the collection of contributions, which are not a revenue of the national budget, but of the mandatory social insurance organisations (MSIO). That means that the public expenditure increase exceeding 200 m Euros as shown in the supplementary budget actually amounts to almost 800 m Euros (1.4% of GDP). A large share of the public expenditure increase was compensated in the supplementary budget by reducing the transfers from the national budget to the MSIO – which is a consequence of increased contribution collection. Therefore, although it is not explicitly shown in the supplementary budget, public revenue of the general government increased by almost 1.7 bn Euros, while public expenditure increased by almost 800 m Euros.

The main reason for the public expenditure increase lies with increased government investments into infrastructure and healthcare, in the amount of over 400 m Euros, which is generally justified. The proposed supplementary budget calls for public investments increase of over 400 m Euros (a part of this increase is shown directly in the supplementary budget, while a part is classified as larger transfers to SOE “Roads of Serbia”, local governments etc. in the national budget). The envisaged public investments increase was almost completely directed at the development of infrastructure and investments into healthcare (transport infrastructure, Clinical Centre of Serbia, Covid hospitals etc) – while capital expenditures for procurement of equipment and weapons for the military and the police were not increased at this time. Due to the envisaged public investment increase, their share in GDP in 2021 will be at a record high of 7.8%. Of that, 6.4% of GDP was allocated to the so-called productive purposes, while investments into the army and the police remained at the level of 1.4% of GDP as was planned in the supplementary budget from April (which is still exceptionally high as other CEE countries allocate five times less for these purposes than Serbia – 0.3% of GDP on average). The Fiscal Council generally sees the increase of public investments into infrastructure and healthcare as a good fiscal policy measure, especially with the still-ongoing public health crisis. Increased infrastructure development is the strongest fiscal stimulus for economic activity acceleration and one of the reasons behind Serbia's rapid economic growth in 2021 – while higher investments into healthcare are currently an indisputable priority

The supplementary budget includes, with some delay, two already adopted measures of direct disbursements for citizens, as well as an increase of expenditures for some of the existing policies. In addition to public investments increase, the proposed supplementary budget formalized two already adopted fiscal policy measures that had not been included in the first supplementary budget from April. These are the non-selective payment of 20 Euros to each citizen of age (to be paid out in December) and 3,000 dinars paid to citizens who took the vaccine by 31

May 2021 (paid out in June), which increased the budget expenditures by almost 200 m Euros compared to the April supplementary budget. The non-selective assistance for all citizens of age (and all pensioners) has been analysed several times by the Fiscal Council, and these analyses show, beyond any doubt, that this was not an efficient economic policy measure; these measures are now additionally dangerous due to accelerated inflation. Providing a financial stimulus to vaccinated citizens is a somewhat more specific measure, but the vaccination trends from May fail to show that it had any significant effect on the increase of population immunization. Other increases of budget expenditures called for in the supplementary budget were individually smaller and pertained mostly to already existing policies (increased subsidies to recyclers and subsidies for e-fiscal registers, direct payments in agriculture etc.) The supplementary budget even decreases some individual items on the expenditure side compared to the plan from April; for instance, the planned expenditure for the payment of minimum wages to private enterprises came in somewhat smaller than had been expected.

The strong public revenue increase is mostly driven by macroeconomic changes. The proposed supplementary budget increases all major revenue items of the national budget, compared to the plan from April. The largest increase of about 450 m Euros comes from VAT collection, followed by corporate income tax (about 370 m Euros), non-tax revenue (over 200 m Euros), excise tax (over 50 m Euros) etc. A strong increase in contribution and salary tax collection should also be added to this list, as well as some other types of public revenue that are not part of the state budget. The steep growth of practically all public revenues compared to the plan is mostly owed to the changes in the macroeconomic environment – a somewhat faster economic growth, sharp inflation acceleration and faster than expected salary and employment growth. The remaining part of public revenue increase can be attributed to more conservative initial planning (profit tax, non-tax revenue).

The Fiscal Council finds the public revenue and expenditures credibly planned, and it is possible that the fiscal deficit in 2021 will be below 4.5%, instead of 4.9% of GDP. The Fiscal Council's analysis shows that, in the proposed supplementary budget, the revenue side is generally objectively planned – but there is still a small risk of their planned increase not fully materializing, primarily when it comes to VAT collection. A possible underperformance of VAT collection from its forecast in the supplementary budget, however, cannot lead to a significant deficit increase compared to the plan – first of all, because it would be small, and it may also be compensated, by the end of the year, by a better collection of other types of public revenue (e.g. non-tax revenue). On the other hand, it is far more certain that not all planned expenditures will be executed by the end of the year, which would lead to a significant deficit decrease. A relatively comfortable position in the elaboration of the October supplementary budget (due to the sharp revenue growth) did not call for a very restrictive approach to public expenditure planning. Hence, the budget maintains the same level of certain expenditures that showed a very low implementation rate in the first nine months, the delays of which are quite unlikely to be made up for by the end of the year. A budget appropriation that will most likely not be fully executed is the procurement of goods and services; additional savings are possible for transfers to the social security finds and for certain subsidies. We therefore estimate that the 2021 deficit will most likely come in at about 4.5% of GDP or even lower, instead of the planned 4.9% of GDP.

Insufficient transparency is an issue that is repeated in this supplementary budget Proposal as well. The Fiscal Council pointed out to the Government, even while assessing the April supplementary budget, that there was a lack of transparency in showing certain budget expenditure items. The proposed October supplementary budget, however, brings no improvement in this matter. It is still unclear what, specifically, is being paid for from the capital budget of the Public Investment Management Office; for which purposes are subsidies paid to road construction companies; what exactly constitutes the purchase of financial assets stated in the budget of Ministry of Finance and Ministry of economy; for which specific projects are the majority of transfers to other levels of government used – with the now standard non-transparency of the vast capital budget of the Ministry of Defence. The total amount of the insufficiently explained expenditures that form a part of the proposed supplementary budget reaches a staggering 1.3 bn Euros. Another issue that we would like to draw attention to is the widely spread non-justified use of the current budget reserves to finance expenditures outside of the standard budgeting procedure. The purpose of budget reserves is to fund those expenditures that are objectively impossible to foresee during the regular budgeting process – a good example is the unplanned expenditures arising from the coronavirus pandemic. However, in 2021, the budget reserves were only used for such expenditures to a small extent (allocations for the construction and equipping of the Covid hospital in Novi Sad and the vaccine factory). About 120 m Euros, i.e., three quarters of the budget reserves used by mid-October 2021, were used as donations to the Serbian Orthodox Church, certain local governments, sports clubs etc.

A relatively low fiscal deficit is taken from 2021 into 2022, amounting to less than 1.5% of GDP. The fiscal deficit of 4.9% of GDP envisaged in the October supplementary budget is still very high. However, within this amount, almost 3.5% of GDP (about 1.8 bn Euros) is allocated to extraordinary measures related to the healthcare crisis – payment of assistance to businesses and the population, investments, and procurements in healthcare (vaccines, Covid hospitals) and extraordinary assistance paid to state-owned enterprises (Air Serbia and others). Since these expenditures, by their nature, do not represent a permanent budget expenditure, this would mean that a relatively low deficit, below 1.5% of GDP, is taken into 2022 from 2021 (and this may be a conservative estimate, considering that the fiscal deficit in 2021 will most likely come in under 4.9% of GDP). We see this result as a good foundation for fiscal policy in 2022.

The Fiscal Council recommends to the Government to plan a budget deficit of about 2% of GDP for 2022. In its strategic document (Fiscal Strategy) from the first half of 2021, the Government announced that it will aim for a general government deficit of 3% of GDP in 2022 – which the Fiscal Council saw as a good plan at the time. However, circumstances have since changed and the Fiscal Council now recommends the Government to plan for a 2% deficit in 2022 instead. Firstly, the fiscal result of 2021 will be better than expected, and this improvement should be accepted and re-confirmed in the 2022 budget. In simple terms, a fiscal deficit of 3% of GDP in 2022 would be an appropriate reduction had the planned deficit of 6.7% of GDP been achieved in 2021. Since the 2021 deficit will be 4.9% (and probably even lower), that means that the 2022 figures should be adjusted for this improvement. At that, a deficit of 2% of GDP in 2022 leaves the Government sufficient space for any possible new anti-crisis measures in 2022, since the deficit (without one-off measures) in 2021, that is carried into 2022, comes in below 1.5% of GDP.

Due to growing macroeconomic imbalances, it is necessary to keep a relatively low deficit in 2022. Last year and in the first half of 2021, the main fiscal policy goals were to mitigate the negative economic effects of the pandemic and to provide incentives for economic recovery. However, in 2021, the macroeconomic landscape changed significantly. In recent months there has been a rapid acceleration in inflation, but also a distinct increase in the current account deficit. The rise of internal and external imbalances taking place in Serbia has not run out of control, but economic policy should address it. In response to these trends, the fiscal policy should become less expansionary, i.e., aim for a somewhat larger fiscal deficit reduction in 2022. A strongly expansionary fiscal policy in 2022 is no longer justified even from the viewpoint of economic activity, as most Serbian businesses have already recovered from the crisis. There is an additional macroeconomic reason for a somewhat stricter fiscal policy in 2022. Due to a global rise in inflation, the most important global economies are already planning for less expansionary monetary policies, which ultimately could lead to a global interest rate growth. Serbia should not allow itself to be caught out by any potential interest rate increase, with a high public debt of almost 60% of GDP (which is where it's at now). A decrease of fiscal deficit to about 2% of GDP in 2022 would lead to an observable and certain reduction of the public debt share in GDP and a decrease in fiscal risk arising from a global interest rate growth.

In 2022, the fiscal deficit should be planned more restrictively due to growing fiscal risks as well. Traditionally, the greatest risk to national public finance comes from the poor operation of the unreformed public enterprises. The largest potential public finance expenditure in 2022 could come from Srbijagas, which will face an already certain gas price increase in 2022. Gas price growth will increase Srbijagas's expenditures in 2022 by at least 200 m Euros, perhaps significantly more than that since the Government has yet to negotiate a new long-term agreement with the supplier. The problem is that Srbijagas will not be able to cover its increased expenditures due to rising gas prices with a proportional increase in its revenue. It was already announced that final (selling) gas prices will not go up for households, meaning that Srbijagas is almost certainly going to suffer losses. In addition, Srbijagas is currently supplying gas to enterprises that are not capable of meeting their obligations even at the current, relatively low gas price (MSK). Such enterprises will not be able to afford higher gas prices, either. Finally, the question is whether city heating plants will be able to pay Srbijagas for the increased fuel costs. In addition to Srbijagas, another state-owned enterprise that could become a fiscal expenditure in 2022 is Air Serbia. Its structural issues in operation have only grown with the pandemic. Aside from state-owned enterprises, another serious fiscal risk comes from the ever-increasing budget expenditures for fines and penalties. There are currently six commercial cases before the International Centre for Resolution of Investment Disputes, and the complaints to the European Court of Human Rights also represent a fiscal risk. In 2020, 1,836 new cases were filed with this court against Serbia, i.e., 2.65 cases per 10,000 population, 5 times higher than the European average and, after Montenegro, the largest number of complaints per capita in Europe.

In 2022, salaries in the public sector should not be increased by more than 6%, and pensions should be indexed using the "Swiss" formula (5.5%) Controlling the growth of pensions and salaries in the public sector remains the main anchor for responsible fiscal policies in 2022. The good news is that there is fiscal space in 2022 for a solid increase in pensions and salaries in the public sector. The pensions should grow by 5.5%, according to the "Swiss" formula, so we recommend to the Government to apply this formula consistently when elaborating the budget for next year. Any modifications of the current formula, which are being increasingly mentioned in public, should not be implemented without a comprehensive and transparent analysis, as pensions are the most sensitive – and the largest – public finance expense. Salaries in the public sector have been growing faster than economic growth for several years now, which is an economically unsound trend and unsustainable in the long term. In 2022, salary growth should be planned at a somewhat lower level than the expected nominal GDP growth. The Fiscal Council estimates that an economically sound approach would be to increase public sector salaries by 6% in 2022, as such growth would not endanger the public finance stability and would allow for a certain increase in the number of employees, by about 1% (there are currently significant shortages of staff in certain public sector segments). The Fiscal Council also recommends to the Government to change its approach in 2022 and finally launch the reform of the salary and employment system in the general government, which it has been announcing since 2013. Instead of a declarative, but unbinding advocacy of a single pay grade system, which has not been implemented for years, we propose to the Government to finally kick off this reform with a small number of 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.