Republic of Serbia

FISCAL COUNCIL **6 November 2022**

ASSESSMENT OF THE PROPOSED SUPPLEMENTARY BUDGET OF THE REPUBLIC OF SERBIA FOR 2022

Summary:

The proposed supplementary budget projects a rise in the budget deficit from 3 to almost 4% of GDP, and the main reason for this increase is related to the enormous losses of state-owned companies in the energy sector. Compared to the initial budget for 2022, the proposed supplementary budget introduces unusually large-scale changes on both the revenue and the expenditure side. Budget revenue has gone up by as much as RSD 193 billion (EUR 1.6 billion), and expenditure has risen even more sharply - by RSD 272 billion (EUR 2.3 billion). As a consequence, instead of the planned budget gap amounting to RSD 200.2 billion (EUR 1.7 billion), the deficit has surged to RSD 279.1 billion (EUR 2.4 billion). There are three main reasons why the proposed supplementary budget differs so significantly from the initial budget. The *first* is related to the strong acceleration of inflation, which for the most part has driven the increase in public revenue. The budget was drafted based on the assumption that the average inflation rate will be 3.7% in 2022, but instead it will reach almost 12%. The *second reason* has to do with the introduction of a large number of expenditure policies into the budget that were not initially planned. However, for the bulk of these expenditures, this is just a formality now since they have already been implemented or are in the process of implementation (EUR 100 for the youth paid out two times, an increase in assistance for the first, second and third child, tourist vouchers, etc.). The *third* and single largest change in the supplementary budget is the financing of the huge losses incurred by public enterprises in the energy sector (Srbijagas and EPS). Direct appropriations amounting to about EUR 1.3 billion have been made in the budget for these purposes, while the total costs imposed on the government are even higher because they are also incurred by issuing guarantees for their borrowing. In the spring of this year, Srbijagas borrowed USD 200 million with a government guarantee, and the supplementary budget has opened up the possibility to issue another EUR 650 million of similar guarantees by the end of the year. The practice so far has shown that at the end of the day such loans are repaid by the government, hence it can rightfully be added to the budget cost of public enterprises in the energy sector.

An unfavorable feature of the proposed supplementary budget is its lack of transparency, especially in the part related to expenditures for the public energy companies. Insufficient transparency of the budget is a problem that has been persisting for years. For instance, since its establishment, the Public Investment Management Office (now transformed into the Ministry) has never seen fit to present the projects on which it has been spending taxpayers' money in its budget. The proposed supplementary budget has further – and strongly – undermined the

transparency of the budget, because the huge cost for the public enterprises in the energy sector has not been presented in detail. The only expenditure that can be clearly identified in the budget refers to RSD 10 billion for the purchase of mining machinery for EPS. The remaining amount of around RSD 140 billion (EUR 1.2 billion) in direct budget costs has only been recorded under the item *Outflows for acquisition of financial assets*, without any explanation. This means that the budget does not specify the amounts (to be) received by each company, the exact manner in which their losses were generated, the purposes for which the budget resources will be used, etc. It is almost unbelievable that the item *Outflows for acquisition of financial assets* (with the aim of implementing public policies) has increased more than 11 times compared to the initial budget (from RSD 13 to RSD 153 billion); that acquisition of financial assets in the budget financing account has gone up 35 times (from RSD 3.8 to RSD 132 billion); that the amending of Article 41 has enabled the government to issue RSD 102 billion in guarantees for borrowing (originally 24 billion) - without being accompanied by a clear explanation to taxpayers. At the same time, room was made in the Rationale of the Budget Law to mention the activity of multinational companies in Ireland.

In principle, the upside of the supplementary budget is that it maintains high allocations for public investment, which will amount to about 7.5% of GDP at the general government level. As a matter of fact, it is not easy to identify in the supplementary budget the actual amount earmarked for public investment because, among other things, a portion of these funds is recorded as transfers (e.g., a transfer to the Health Care Fund for the construction of clinical centers). Still, a more detailed analysis shows that the supplementary budget has kept a very high amount of government capital investments, almost as planned in the initial budget. At the general government level (including the estimate for local self-governments), we expect spending on public investment to amount to a high 7.5% of GDP (around EUR 4.5 billion). Out of that amount, about 0.5% of GDP refers to an increase in commodity reserves (which are accounted for as investments), and about 1% of GDP is earmarked for equipment for the army and the police. Consequently, investments that constitute "true" public investments, which are by definition the best type of public spending from the economic standpoint, amount to about 6% of GDP. This is a very good result, especially against the backdrop of the slowdown in economic activity. Nevertheless, the recommendations of the Fiscal Council that we made in our previous reports are still applicable here – to the effect that it is necessary to present in more detail the actual projects on which these funds are spent, the method used to select them (and in general how the government's priorities for major investments are chosen), to provide a cost-benefits analysis of selected projects, etc.

The supplementary budget has increased the total budget revenue by almost RSD 200 billion (EUR 1.6 billion). Based on the relatively high public revenue collection so far, the Ministry of Finance has increased budget revenue by almost 13% in the supplementary budget. That is an unusually sizeable change. The main factor underlying this increase is the strong acceleration of inflation - because when prices of products and services go up, the tax that the government collects from them also goes up. The initial budget was prepared based on the assumption that the average inflation rate in 2022 would be 3.7%, but it will reach almost 12%. The acceleration of inflation has directly contributed to the increase in VAT, whose collection will be roughly EUR 800 million higher than initially planned. A similar explanation can also be given for the unexpectedly high growth in customs revenue, which will overperform by almost EUR 150 million - mostly due to the increases in prices of imported goods, and to a lesser extent owing to the increase in the physical volume of imports. However, the acceleration of inflation is not the only reason for the increase in public revenue. The revenue item that significantly overperformed compared to the expectations is the corporate income tax, namely by around EUR 450 million. The corporate income tax in 2022 is levied on the profits posted by companies in 2021. The high profits of businesses in 2021 (they were high in 2020 as well) are not fully in sync with the economic activity trends. It is, therefore, possible that they are associated with large and non-targeted subsidies from the budget for the anti-crisis measures (payment of minimum wages and the like). The government also granted (unwarranted) aid to companies that did not face problems in business operations, which most likely enabled part of the businesses to make windfall gains and increase their profits. The increase in budget revenue by around EUR 200 million is also driven by a rise in non-tax revenues. The NBS (unexpectedly) paid about EUR 50 million of profits to the budget, and the remainder is a consequence of the higher collection of charges for the use of mineral raw materials, as well as other fees and levies, which is probably partly connected with the acceleration of inflation.

On the expenditure side, new policy measures were introduced into the budget in the total amount of about RSD 65 billion (EUR 550 million). A frequent and bad practice in the pursuance of economic policy in Serbia is that many measures are adopted and implemented ad-hoc, apart from the regular budget procedure. A peculiarity of its own kind occurred towards the end of the previous year, a mere day after the adoption of the 2022 budget, when high-level state officials announced the implementation of new population policy measures in 2022 (increase in benefits for the first child, introduction of one-off assistance for the second and the third child, etc.) - although this was not even mentioned in the recently adopted budget. These entitlements, for which more than EUR 120 million will be set aside in 2022, have been paid since the beginning of the year and now they have finally been officially budgeted in the supplementary budget. Furthermore, three non-targeted payments to all citizens aged 16 to 29 (two times EUR 100 plus RSD 5,000 at the end of the year) have been included in the supplementary budget - the cost of which is around EUR 250 million. The Fiscal Council has repeatedly assessed such benefits as wrong from economic and social standpoints. That is why we call on the Government once again to finally abandon these and similar wasteful and untargeted policies. Also, spending on tourist vouchers has been increased (about EUR 30 million), and there were other similar measures (which could have been incorporated in the initial budget). The only new measure from this set, which could have some justification in extraordinary circumstances, refers to increased expenditure for agriculture in the amount of EUR 130 million (for the purchases of fuel, fertilizers, etc.). The new policies definitely include a 9% increase in pension benefits as of November (paid out through the Pension Fund). This increase, however, will not exert an impact on the increase in the planned government expenditure for pension benefits in 2022, because the number of pensioners has decreased in the course of the year by about 1.5%. However, in 2023 (with regular indexation from January), it will raise the pension expenditure.

The supplementary budget has increased expenditure on commodity reserves by around EUR 300 million. Expenditures for commodity reserves have been increased in the supplementary budget from around EUR 40 million to over EUR 330 million. This is another large-scale change in the budget that calls for a much better explanation from the Government. It is clear that the prices of goods purchased for strategic reserves have gone up sharply in 2022. It is also clear that global uncertainties have imposed the need for the state to increase its commodity reserves, especially of goods with respect to which there is import dependency (e.g., petroleum products). However, the increase in expenditure for commodity reserves by as much as six to seven times relative to its usual annual level of about EUR 50 million a year (as well as relative to the initial budget plan), raises questions about potential problems in the functioning of the current system of commodity reserves in Serbia.

Huge expenditures to cover the losses of SOEs in the energy sector are the most important change in the supplementary budget. Had it not been for the huge expenditures on Srbijagas and EPS, Serbia's budget would have had a deficit of less than 2% of GDP in 2022. Such a result – even with all the objections to certain economic policies and the already habitual lack of transparency – could in principle receive a favorable assessment. However, the immense losses of those two companies have caused the government deficit in the supplementary budget to widen to almost 4% of GDP (and this should be increased by the costs of the issuance of government guarantees). Therefore, this year's fiscal cost of covering the losses incurred by the public enterprises in the energy sector (including guarantees) amounts to about EUR 1.5 billion. Moreover, it could be even higher if the Government approves new debt guarantees for these companies by the end of the year. When the fiscal costs incurred for the same purposes in late 2021 are added to that amount, it is clear that Srbijagas and EPS have already cost the budget about EUR 2 billion – and it is obvious that these expenditures will also continue to exist into 2023. The reasons for such heavy losses can only partly be sought in the global energy crisis. In the case of Srbijagas, the responsibility is divided between uncontrollable external circumstances, domestic policies of the Government and many years of mismanagement in the company. When it comes to EPS, its current problems are almost entirely caused by the terrible management of the company in the previous years.

Currently, the main problem of Srbijagas is the low selling price of gas on the domestic market, as well as the shortage of storage capacity. Srbijagas is almost entirely dependent on imports of gas, which it then sells. Although a relatively favorable formula has been achieved for the purchases of gas from Russia under a long-term contract (a variable price, currently at around EUR 400 per cubic meter), Srbijagas is generating losses even at this price because its selling price of gas is too low. An additional problem is related to the fact that the long-term contract with Russia does not cover entire gas consumption in the country, so the difference must be compensated by purchasing gas on the market at several times higher prices - which further pushes Srbijagas into even heavier losses. The greatest responsibility for the low selling price of gas on the domestic market (and the resulting losses) rests with the government, not the company. With the Decree on the Temporary Gas Price Cap, the Government has *de facto* opted for an arrangement in which the difference between the buying and the selling price of Srbijagas will be paid by all taxpayers rather than by consumers who consume gas. This substantial cost now appears in the supplementary budget (although nothing in that respect has been clearly explained or quantified). Apart from the price of gas on the domestic market, which should anyhow be sharply increased, the problem of Srbijagas is also related to the fact that it has not built storage capacities that would guarantee the energy stability of the country (despite such announcements ever since 2011). That is why capacities in Hungary are currently being rented for gas storage purposes. Finally, it should also be noted that a significant portion of the losses and budget costs for Srbijagas, incurred late last year and early this year, was also caused by the fact that the existing gas storage facility in Banatski Dvor was poorly managed - with this storage facility seeing the previous heating season insufficiently filled.

The main problem of EPS is the shortfall in production, caused by mismanagement and lack of investment in previous years. In the course of the previous decade, through mismanagement, EPS has been turned from an electricity exporter into a net importer. This is now generating huge losses, as the electricity price on the international market stands at its all-time high. In the first nine months of 2022 alone, EPS generated a loss of about RSD 80 billion (EUR 680 million). The company is not able to finance this loss on its own, which is why it has accumulated substantial arrears to suppliers. It is clear that EPS can no longer operate without a financial boost from the budget (or a guarantee for borrowing). For the government, however, besides the need to deal with urgent problems, there remains the question of how it is possible that a new coal mine has not been opened in Kolubara, even though it was abundantly clear five years ago that it was a necessity. Moreover, one has to identify why distribution grid losses (and electricity thefts) are huge, why EPS is the biggest polluter in Serbia, why the distribution grid is in a shambles, why labor costs are high, why the average number of bidders on EPS tenders has dropped over the previous years to a mere 1.7, etc. All these perennial problems cannot be explained by the low selling price of electricity, although its increase was undeniably justified (and long overdue).

With the exception of the costs for the energy sector public enterprises (which have remained an unknown for the most part), the rest of the budget is credibly planned. Forecasts of public revenue and public expenditure (excluding energy) in the supplementary budget have been made objectively. The Fiscal Council's analysis shows that there is a tendency with respect to certain budget items to be a bit more generously planned, which is in line with good budget practice. For that reason, instead of the planned fiscal deficit amounting to 3.9% of GDP, the actual budget deficit could be somewhat lower in the end, possibly around 3.5% of GDP. This estimate, however, was made without full knowledge of the composition and purpose of expenditures for the losses of the public enterprises in the energy sector - because this is not presented at all in the supplementary budget. That is why the Fiscal Council remains somewhat reserved regarding the assessment of fiscal trends by the end of the year.

Due to macroeconomic changes (acceleration of inflation coupled with the stable exchange rate), the share of public debt in GDP will decline in 2022 - but these are transitory effects. Another specific feature of 2022 is that the deteriorating macroeconomic developments (acceleration of inflation coupled with a slowdown in GDP growth) have actually had an overall positive effect on fiscal trends. High inflation strongly pushed up public revenue performance but did not have the same impact on public expenditure. During 2022, this has contributed to the narrowing of the fiscal deficit. However, these are transitory effects. Acceleration of inflation will soon be incorporated into the pension increases (also envisaged by the currently applicable "Swiss" formula) and will definitely contribute to a stronger increase in wages and salaries in the public sector, along with a higher-than-usual rise in other budget expenditures. On the other hand, as a consequence of higher inflation, the purchasing power of the population will diminish, resulting in a gradual exhaustion of its positive impact on public revenues. This is already clearly discernable in the deceleration of the VAT collection towards the end of 2022. Similar conclusions apply to the debt to GDP ratio. Due to the acceleration of inflation (with the stable exchange rate of the dinar against the euro), the nominal GDP has grown very strongly in 2022 - it will amount to over EUR 60 billion, compared to the originally projected EUR 56.5 billion. This, however, is not a positive economic result, because with this new GDP of EUR 60.3 billion, one can now buy fewer goods and services relative to the original projection (of EUR 56.5 billion, but with inflation of only 3.7%). From a fiscal point of view, however, this very high nominal GDP growth has had positive implications. It has resulted in the slight decline of the share of public debt in GDP in 2022, although the country's indebtedness will increase sharply, by around EUR 3 billion. Still, these trends are short-lived. Due to high inflation, the world's most important central banks are tightening their monetary policies, as reflected in the general increase in interest rates on borrowing. Perceived from the point of view of investors lending to Serbia, steady devaluation of their investments due to high inflation will be unacceptable to them, too. Because of all this, there has already been a steep hike in interest rates on Serbia's borrowing, which will certainly continue in the coming period. Accordingly, durable fiscal improvements cannot rest on sudden macroeconomic changes, such as a rapid acceleration of inflation. The only sustainable way to do this is to conduct a responsible fiscal policy.