Republic of Serbia

FISCAL COUNCIL

1 October 2024

ASSESSMENT OF THE PROPOSED SUPPLEMENTARY BUDGET OF THE REPUBLIC OF SERBIA FOR 2024

Summary:

The proposed supplementary budget increases the 2024 fiscal deficit from the originally planned 2.2% of GDP to 2.9% of GDP. The main feature of the proposed supplementary budget is a strong surge in public expenditures. Compared to the initial budget plan, their growth amounts to as much as RSD 198 billion (nearly EUR 1.7 billion). Although the supplementary budget has also raised budget revenues substantially (by almost RSD 133 billion, i.e., more than EUR 1.1 billion), it was not enough to offset the budgeted expenditure spike. Therefore, the final result of the proposed supplementary budget is an increase in the fiscal deficit from RSD 197 billion (about EUR 1.7 billion) to RSD 263 billion (more than EUR 2.2 billion). Viewed as a share of GDP, the budget deficit is projected to go up in 2024 from 2.2% of GDP to 2.9% of GDP. After three consecutive years of gradual budget balancing, this supplementary budget marks a shift in Serbia's fiscal policy. Following a crisis deficit of 8.3% of GDP in 2020, the state budget deficit steadily decreased to 4.5% of GDP in 2021, then to 3.3% of GDP in 2022 and finally to 2.2% of GDP in 2023. The proposed supplementary budget reverses this trend.

The Fiscal Council cautions that the supplementary budget could be a step in the wrong direction if higher capital investment failed to result in an accelerated GDP growth. Serbia's economic growth in 2024 is solid (the Government forecast stands at 3.8%) and does not call for additional fiscal incentives – particularly given that domestic demand, fueled by fiscal expansion, grew significantly faster than GDP in the first half of the year. Furthermore, inflation in Serbia remains among the highest in Europe despite a rather sharp deceleration in late 2023 and early 2024. In this macroeconomic context, it would have been appropriate to opt for a further narrowing of the fiscal deficit, for which prerequisites were in place in 2024 (public revenues in the first eight months of 2024 were substantially higher than planned). Nevertheless, the government chose a different path, opting for a sharp increase in budget expenditures by the end of the year and a consequent widening of the fiscal deficit.

It should also be borne in mind that the government is currently borrowing at high interest rates. The unfavorable terms under which Serbia is borrowing constitute an additional important argument why the Fiscal Council has adversely assessed the shift in the fiscal policy stance in the proposed supplementary budget. The interest rate on the most recent Eurobonds issued by the government exceeded 6%, and loans taken from commercial banks in 2024 to finance certain public projects (the Kragujevac ring road, the Šabac-Loznica traffic route, the Danube main road, and the National Stadium) were even less favorable, with interest rates ranging between 8% and 9%. Due to the deterioration of borrowing terms and the

(nominal) increase in public debt, the state budget expenditures for interest payments have gone up sharply over the past two years – from RSD 105 billion in 2022 to a projected RSD 185 billion in the 2024 supplementary budget, which is an increase of almost EUR 700 million. One peculiar aspect of the current fiscal policy is that the government was already borrowing heavily before the budget revision, which is why it currently has large deposits in its account. The existence of those funds, however, is not an objective argument to justify a large increase in public spending. Instead, the large (and expensive) deposits that the government currently has at its disposal could be used to repay maturing public debt, rather than to finance new budget expenditures.

The positive aspect is that the planned deterioration of fiscal developments is unlikely to undermine Serbia's macroeconomic stability. The planned increase in the fiscal deficit will inevitably lead to higher national indebtedness, regardless of the current level of deposits. However, a mitigating factor is that nominal GDP in 2024 is growing even faster, so the public debt-to-GDP ratio will still decrease slightly. Serbia's GDP growth in euro terms is projected to be nearly 10% in 2024 (from EUR 69.5 billion to EUR 76.4 billion), while the general government's public debt will increase by about 6% (from EUR 36.5 billion to around EUR 38.5 billion). Consequently, the public debt-to-GDP ratio will decline from 52.3% at the end of 2023 to below 52% at the end of 2024. Serbia's GDP growth in euro terms is projected to be nearly 10% in 2024 (from EUR 69.5 billion to EUR 76.4 billion), while the general government's public debt will go up by about 6% (from EUR 36.5 billion to around EUR 38.5 billion). Thus, the share of public debt in GDP will decline from 52.3% of GDP, which was the ratio at end-2023, to below 52% of GDP at end-2024. This suggests that the planned fiscal deficit widening will not undermine the country's fiscal and macroeconomic stability. However, some additional factors warrant caution. Firstly, the high GDP growth in euro terms of around 10% in 2024 is for the most part based on factors that are not sustainable in the long run. In addition to solid real GDP growth of 3.8%, it is also driven by the still relatively high average inflation (4.7%), a higher GDP deflator of 5.7% (due to the growth in domestic prices, which is faster than that of import prices), and a slight nominal appreciation of the dinar against the euro. Secondly, due to high interest rates, the cost of servicing Serbia's public debt of about 50% of GDP is relatively high. Serbia's budget expenses for interest payments in 2023 amounted to 1.8% of GDP while in France, for example, they were 1.7% of GDP – even though Serbia's public debt to GDP ratio at end-2023 was 52.5% and that of France 110.5%. Therefore, comparisons between the size of Serbia's public debt and the public debt of economically more developed countries are not economically meaningful.

It is also important to notice that the deficit widening planned by the supplementary budget is not structural (permanent) in nature. The specific reasons for the planned increase in the fiscal deficit will be discussed in more detail later. However, it should be noted here that it is mainly attributable to a rise in discretionary rather than structural government expenditure (structural expenditure would be, for example, an increase in pensions and public sector salaries, which becomes a permanent statutory obligation of the government, if once introduced). This implies that the budget can relatively easily return to balance in the future. With the completion of certain initiated projects, this could take place automatically and, if need be, in the coming years the Government can also relatively quickly adjust public expenditures to public revenues. This significantly reduces the economic risk associated with the fiscal deficit widening planned by the supplementary budget. One of the good features of the proposed supplementary budget could be the fact that this time, unlike in the previous few years, the Government has refrained from indiscriminately distributing one-off payments to large segments of the population – a practice that is unsound from both an economic and social perspective.

The budget is credibly and conservatively planned, so there is a possibility for the 2024 fiscal deficit outturn to be slightly lower than the new plan from the supplementary budget. The analysis of the Fiscal Council shows that there are no major risks of a public revenue shortfall compared to the forecast in the supplementary budget, or of a public expenditure overrun relative to the plan. On the contrary, public revenues have been projected moderately conservatively, so there is a possibility that they exceed the budget plan. In addition, it is quite likely that some expenditures have been budgeted too generously and that they will not be fully executed. This means that the fiscal deficit in 2024 could easily end up being lower than the planned 2.9% of GDP. In such a case, it would be very important for the Government to refrain from adopting new *ad hoc* measures to be implemented through the contingency reserve (which was a frequently used practice in previous years). From an economic standpoint, it is much more prudent and reasonable to use potentially more favorable fiscal developments to reduce the budget deficit and the consequent borrowing of the country.

The largest increase in expenditure occurred under the item Investment, which can be almost entirely explained by two projects (EXPO 2027 including the construction of the National Stadium and the purchase of *Rafale* fighter jets). The item in the supplementary budget that has seen the steepest rise refers to capital expenses - from RSD 467 to 570 billion, i.e., an increase of more than EUR 850 million. It implicitly means that public investment at the level of the consolidated general government (including local governments, social security funds, the public company Corridors of Serbia) has now increased to over EUR 6 billion in 2024 (about 8% of GDP), which is a record-high for Serbia. A more detailed analysis of the composition of the envisaged increase in public investment reveals that this is mostly due to two large blocks. These are: 1) EXPO 2027 with the accompanying infrastructure (the National Stadium and the railway from Zemun to the Stadium), the costs of which in 2024 have been increased in the supplementary budget by about EUR 370 million (from the initially planned EUR 340 million to EUR 710 million); and 2) investments of the Ministry of Defense, which went up in the supplementary budget by about EUR 450 million (due to the payment of the first installment for *Rafale* fighter jets and the preparation of infrastructure for the introduction of compulsory military service). The total allocation for other investment projects of the government has increased slightly compared to the initial budget plan.

The country's investment policy needs to be brought back into a regulated, systemic framework. Despite the fact that "on paper" Serbia has very good and transparent procedures for the selection and management of public investments, most of the current government investment projects are exempt from these procedures. Management of large-scale public projects with partial or complete exemption from the general laws and regulations governing public procurement, expropriation, planning and construction, etc. is plagued by a number of weaknesses and risks that the Fiscal Council has already pointed out (see the report: "Public Investment Policy in Serbia: Situation Analysis and Recommendations for Possible Improvements" of June 2024). The proposed supplementary budget, which is raising public investment to a record-high level, and ambitious plans for the coming years further emphasize the need for better regulation and enhancement of Serbia's current public investment policy. In the first step, the enhancement should be related to greater transparency. Taxpayers should be provided with much better information about the costs (and benefits) of large-scale government projects and the prioritization method, as well as with a detailed explanation of the reasons for the massive upward revisions of the originally contracted prices of multiple initiated projects (the Morava Corridor, the Ruma-Šabac-Loznica road, the Danube main road, etc.).

In addition to public investment, substantial increases in the supplementary budget pertain to subsidies for agriculture and expenditures for social policy and for healthcare. After the initial reduction in agricultural subsidies by RSD 13 billion in the original budget for 2024 compared to 2023 (which has never been clarified in detail), their amount is

now increased by about RSD 18 billion in the supplementary budget (again without a clear explanation). Moreover, the most recent increase in subsidies has been coupled with a cut in expenditures for rural development measures worth about RSD 3.5 billion. Agriculture is a very important sector of the domestic economy, accounting for about 7.5% of the Serbian economy (or for more than 10% when combined with the food industry), which is one of the highest shares in Europe. For that reason, the country's vacillation in agricultural policy, which is being revised several times within a year, is inappropriate bearing in mind the importance of this sector. Social benefits have been increased in the supplementary budget by about RSD 26 billion for several reasons. First of all, this supplementary budget corrects a mistake made in the original budget, which did not take into account the additional costs of regular indexation of the amounts of benefits (by price and wage growth) and the long-term effects of previously adopted measures (parental allowance for the third and fourth child) – which was also pointed out by the Fiscal Council in its Assessment of the 2024 Budget. Furthermore, the Constitutional Court ruling to indemnify the beneficiaries of maternity leave benefits for the incorrect calculation of the benefits in the period from April 2019 to January 2024 (which could not have been foreseen during the budget preparation) contributed to the rise in social protection costs. The proposed supplementary budget, however, has made a new oversight since it did not account for the increase in the expenditure for parental allowance of about RSD 5 billion, due to amendments to the Law on Financial Support for Families with Children (which were submitted to the parliament for adoption concurrently with the supplementary budget). The increase in health care expenditures of RSD 20 billion (through transfers to the National Health Insurance Fund) is a consequence of higher allocations for medicines and medical devices (caused by the expanded scope of the insured persons' right to treatment with innovative drugs, etc.), and the planned rise in the number of health workers and surgical operations, which is in line with the statements by ranking state officials about stepping up efforts to shorten the long waiting lists. If the newly allocated funds help solve the above problems of the public health care system, the increase in these costs will be appropriate and justified.

The budget revenues have been (justifiably) increased by about RSD 133 billion. The public revenue collection in the first eight months of 2024 significantly overperformed the budget plan. This was recognized in the supplementary budget, in which the Republican revenue forecast was increased by about RSD 133 billion compared to the initial plan – mostly on VAT (52 billion), corporate income tax (35.5 billion) and non-tax revenues (28.5 billion). Additionally, it can be implicitly seen in the supplementary budget that the government has substantially increased its forecasts of contributions for mandatory social insurance. This is not directly reflected in the revenue side of the Republican budget, because these revenues are registered in the financial statements of social security funds, but rather indirectly, on the expenditure side, through lower budget transfers to these funds (primarily to the Pension and Disability Insurance Fund). The planned increase in public revenues proposed by the supplementary budget is broadly in line with the Fiscal Council's own estimates. That is why we have assessed these forecasts of the Ministry of Finance as objective (probably even moderately conservative).

The proposed supplementary budget is not sufficiently transparent in certain segments. Similar to the practice in the previous years, the supplementary budget for 2024 does not offer necessary explanations for many important changes in budget revenues and expenditures. On the public revenue side, for example, the Government should explain in more detail the strong increase in windfall non-tax revenues, which have gone up in the supplementary budget from the initially planned RSD 27 billion to almost RSD 51 billion. There is only one sentence in the Explanatory Note of the supplementary Budget Bill, which does not provide either a quantitative or qualitative explanation for this change: "... *due to the collection of revenues that were not included in the original budget plan (NBS profit and budget*

dividends)". On the expenditure side, the problem of insufficient transparency is far greater. For example, the Ministry for Public Investment (former Public Investment Management Office – PIMO) should present all of its projects with much more detail, following the good example of the Ministry of Transport, Construction and Infrastructure; an explanation of the structure and purpose of expenditures for net lending (which have been sharply reduced by this supplementary budget) is still missing; the (financial) relationship between the Republican budget and EPS is unclear (the supplementary budget introduced new budgetary position for acquisition of financial assets for the construction of the Kostolac B3 power plant, but also new appropriation for the construction of autonomous solar power plants with battery storage systems); Government should also provide an explanation for the delay in the execution of some important infrastructure projects, such as, for example, the project of collecting and treating wastewater of the Central Sewerage System of the City of Belgrade.

The supplementary budget is yet again to be adopted in the urgent procedure, which is an unjustifiable practice that should be abandoned. The proposed supplementary budget brings major changes in the budget, especially on the expenditure side. It has already been mentioned that the (net) increase of expenditures is sharp – relative to the initial budget, it amounts to about EUR 1.7 billion. However, it should be borne in mind that there are also some expenditure cuts - for instance, owing to higher collection of mandatory social contributions the need for transfers to social security funds has been reduced, and the (non-transparent) costs of net lending have also been decreased probably due to the lower import price of gas. As a result, the new and increased expenditures in the supplementary budget are even higher than EUR 1.7 billion, i.e., they amount to nearly EUR 2.2 billion. Therefore, taxpayers should be able to carefully and thoroughly review such major changes via their representatives in the Parliament. Nevertheless, the last time when the supplementary budget was discussed and adopted in the regular parliamentary procedure was back in 2019. Since then, unjustifiable practice of adopting this important document through urgent procedure has again been introduced, which does not allow sufficient time for MPs to prepare and propose constructive amendments – i.e. leaves no space for a productive parliamentary debate.