Republic of Serbia
FISCAL COUNCIL

ASSESSMENT OF THE PROPOSED LAW ON AMENDMENTS TO THE BUDGET LAW OF THE REPUBLIC OF SERBIA FOR 2023

SUMMARY

According to the Law on Budget System (Article 92h), the Fiscal Council prepares and submits to the National Assembly an analysis of the budget rebalancing proposal of the Republic of Serbia within 15 days after the date of submission of the rebalancing proposal by the Government to the National Assembly.

The rebalancing proposal was adopted at the Government session held on Saturday, September 2, 2023, and the session of the Parliamentary Committee on Finance, State Budget, and Control of Public Spending (at which the Fiscal Council was expected to present its analysis) was scheduled two days later, on Monday, September 4, 2023.

In these circumstances, the Fiscal Council decided to prepare and deliver to the Committee the most relevant evaluations of the rebalance in the form of a shortened report, i.e., the Summary. The analyses presented in this Summary were prepared mainly based on the Draft Law on Amendments to the Budget Law, not the Proposed Law on Amendments to the Budget Law. The Draft Supplementary Budget was submitted to the Fiscal Council according to the regular procedure for beneficiaries of budget funds on Friday, August 25, 2023.

The Fiscal Council will subsequently submit the final assessment of the Proposed Supplementary Budget to the National Assembly as soon as possible.

Although the proposed Supplementary Budget projects a moderate decrease in the budget deficit (from 3.3 to 2.8% of GDP), its main feature are new and large expenditure measures. The current year, 2023, is marked by high inflation and low economic growth, which makes it economically very challenging. However, despite the unfavourable macroeconomic environment, fiscal trends in 2023 have been relatively good and significantly more favourable than expected. The mild winter, the global drop in the price of energy products, and the increased production of EPS resulted in the budget costs for financing the collapsed domestic energy sector being almost halved compared to the plan. The Government also used the global drop in the price of energy products in March 2023 to cancel the earlier decision on the temporary reduction of excise duties on oil products, thus affecting the increase of these public revenues significantly above the plan. Also, an unexpectedly large profit tax was collected in 2023, given that some economy segments had record profits in 2022 (for example, NIS made a profit in 2022 that was more than six times higher than the average of the previous three years). If there were no Supplementary Budget, changes in public revenues and public expenditures would result in a significant and desirable decrease in the fiscal deficit from the planned 3.3% of GDP to below 1.5% of GDP, thereby reducing country's borrowing needs by approximately EUR 1.3 billion compared to the initial budget plan. However, instead of the above, the Government introduced new and large expenditure measures through the Supplementary Budget, almost bringing the fiscal deficit and state borrowing back to the initially planned level. The main measures are: 1) an increase in subsidies for agriculture; 2) an extraordinary increase in pensions; 3) an increase in wages for employees in education and the health sector; and 4) a one-time payment of 10,000 dinars for each child up to 16 years of age. In addition to these measures, state officials announced a new payment to pensioners in 2023, RSD 20,000 per person, amounting to EUR 285 million in total. This measure was made public two days after the Supplementary Budget for 2023 was adopted by the Parliament.

The good side of the Supplementary Budget is that the basic fiscal flows did not get out of control. The planned budget deficit of 2.8% of GDP is undeniably high, especially considering that the fiscal rules stipulate that the targeted fiscal deficit of Serbia (with the current level of public debt) should be below 1,5% of GDP. However, objectively speaking, the planned deficit cannot be considered alarming. Namely, it is true that it directly leads to an increase in public debt of almost EUR 2 billion in 2023, which is bad, but GDP (in EUR) will grow even faster in 2023 due to high inflation and a stable exchange rate. Therefore, the debt-to-GDP ratio will not increase even with such a large budget deficit (actually, it will decrease slightly). The good side of the planned Supplementary Budget is that it is credibly planned, i.e., there is no appreciable risk that public revenues will fall short and public expenditures will exceed the plan. On the contrary, it is quite possible that some expenditures, such as expenditures for the procurement of goods and services, are 'over-budgeted', meaning the 2023 fiscal deficit could easily be lower than the planned 2.8% of GDP. In the end, it is good in principle that very high allocations for public investments are retained, which at the level of the general government (including local governments and other segments of the state outside the central government budget) will amount to over 7% of GDP. Here, however, we draw attention to the still unresolved issues of selecting priority projects, as the Fiscal Council has written about on several occasions.

The proposed Supplementary Budget, however, brings more economically unsound and questionable changes. At the beginning of this text, we already pointed out one of the main objections to the proposed Supplementary Budget. The objection refers to missed opportunity to reduce the fiscal deficit to below 1.5% of GDP, thus significantly reducing the country's indebtedness and bringing public finances into calmer waters. In addition, a significant problem with the new expenditure measures is that they are not economically efficient and socially justified, so they do not provide a good response to the challenges the domestic economy is currently going through. This gives the impression that the new measures were designed ad hoc without necessary economic analyses of their effectiveness (which have not been presented and made available for the general public).

The problems in agriculture were not recognized in a timely manner, and the solutions offered now are expensive, while their effectiveness remains questionable. In the last few years, the prices of inputs for agricultural production have risen sharply. Pressured by other problems, the Government simultaneously adopted specific measures that put an additional burden on this sector (the ban on the export of some agricultural products during 2022 and part of 2023, freezing the selling prices of basic foodstuffs, in an attempt to control inflation, for too long). However, instead of recognizing the problems of agriculture in time and coming up with sound solutions through a thorough analysis, the Government has hastily introduced expensive new measures under the pressure of the escalation of farmers' protests. Thus, payouts per hectare have been increased from 9,000 to 18,000 dinars, premiums for milk from 15 to 19 dinars per litre, and incentives for quality breeding dairy cows from 30,000 to 40,000 dinars per head, increasing the budget subsidies for agriculture in 2023 (and the following years) by about EUR 250 million. In addition, an agreement has been reached on measures effective as of January 2024, additionally affecting the growth of future budget expenditures (e.g., raising the limit for receiving subsidies per hectare from 20 to 100 hectares). The most expensive and problematic new measures relate precisely to the increase in payments (and easing of criteria) for subsidies per hectare. Since the amount of these subsidies is not conditioned by realized production, it does not incentivise an increase in efficiency or solve any structural problems in domestic agriculture. The crucial bottlenecks of this system are the lack of infrastructure for storage and transport, backward mechanization, poor technical and technological equipment, problems in distribution, and others, as recognized a long time ago by the Government itself (Strategy for Agriculture and Rural Development of Serbia for the period from 2014 to 2024). However, instead of finally starting a significant reform of this system, the Government decided to solve the growing problems of agriculture 'hastily', with expensive and obsolete instruments.

The extraordinary and arbitrary increase in pensions breached the fiscal rules established by Law, which is very dangerous. Pensions are (along with salaries in the public sector) by far the highest budget expenditure. Therefore, them being in line with the ability of the economy to finance them is crucial for the sustainability of the entire public finances. The problems that can arise as a result of arbitrary increases in pensions can best be illustrated by the 2008 episode, when an economically unjustified increase in pensions practically led to the collapse of public finances of Serbia (the total increase in that year was nominally over 35% and, in real terms, i.e., adjusted for inflation, almost 25%). Therefore, in the following years, pensions were temporarily reduced, with periods of freezing and slow increases, until they finally returned to an economically sustainable level. That painful adjustment enabled the Government to determine a good pension indexation formula (according to objective economic trends) at the end of 2022, which was codified into Law as part of the fiscal rules. It seemed at the time that an important lesson about the management of public finances had finally been learned and that Serbia had entered the group of regulated countries which rely on an objective and predictable formula for pension increases. However, not even a year has passed since the adoption of the Law, and now the pensions have been extraordinarily increased again according to a completely arbitrary criterion, i.e., without any grounding in economic trends. Indeed, their extraordinary increase of 5.5% is not within the same order of magnitude as the one in 2008, which is why it cannot lead to the collapse of public finances this time. However, this increase undeniably sets a rather dangerous precedent. It also sends a bad message about the credibility of state policies because the Government has decided to break the Law it recently enacted itself.

The quite bad practice of indiscriminate cash payments to specific groups of residents continues. The Supplementary Budget projects the payment of approximately EUR 100 million out of the budget for cash benefits of RSD 10,000 for each child up to 16 years of age (which should be realized at the end of September 2023). Mothers or single fathers are entitled to the money. The Fiscal Council has warned countless times about the poor practice established with the outbreak of the health crisis in 2020, i.e., that social policy is conducted through one-time and indiscriminate cash benefits to the population. The criterion for financial aid payment, linked exclusively to age, is socially unfounded and, therefore, unacceptable. The only correct basis for awarding financial aid to citizens is the degree of their social vulnerability through permanent and organized channels of regular social benefits, which are largely neglected in Serbia. At the same time, one should keep in mind that, as a result of the payment of such economically and socially unjustified forms of financial support, the citizens of Serbia have accrued additional debt of approximately EUR 2 billion since 2020, at a very high interest rate (currently around 7%).

The new expenditure measures will be funded through the country's debt as well as tax increases. Increases in multiple categories of public expenditure at the end of the year by amending the budget has already become a common practice in Serbia. For example, last year, the largest part of the extraordinary increase in budget expenditures was related to covering the losses of public energy companies (Srbijagas and EPS). However, in contrast to previous years, when the additional public expenditure increases were mostly one-offs, this time the Supplementary Budget introduces large expenditure measures that are permanent. The extraordinary increase in pensions and agricultural subsidies represent long-term commitments that will continue to burden the public finances of Serbia in the future, even after the end of 2023. In this regard, in agreement with the IMF, the Government has officially committed to offset these permanent expenditures against other permanent fiscal policy measures. The specific measure agreed upon and introduced by this Supplementary Budget is an exceptional increase in the excise duty rate on all excise products of 8%, effective as of October 2023.

The new economic measures introduced by the Supplementary Budget do not are not appropriately address the economic problems Serbia is facing. As we mentioned, the main macroeconomic challenges Serbia is facing in 2023 are high inflation and low economic growth. At the same time, a separate problem with high inflation is that food and energy prices have gone up the most. Such an inflation structure threatens especially the poorest citizens of Serbia, who allocate the largest part of their income to these products. Therefore, in such circumstances, it would be justified for the Government to direct its economic policies towards higher support for citizens who are objectively socially vulnerable and, if possible, implement measures to stimulate economic growth (which could, for example, be tax relief). However, the measures brought about by the Supplementary Budget are nowhere near as targeted, and, in some cases, they are even counter-productive. The distribution of money to all citizens of a specific age (from borrowings) is not only a wasteful and poorly targeted social policy by definition, but it also acts economically as inflationary. Therefore, its ultimate impact on the most socially vulnerable segments of the population is questionable, to say the least. The same can be said about the expected increase in excise taxes. It not only has a recessive effect on the economy by its nature but also directly leads to an increase in prices, thus directly reducing the standard of living of the citizens of Serbia.

The decline in VAT collection is worrisome because it may indicate serious structural problems in the operation of the Tax Administration. The only significant item of public revenues reduced by the Supplementary Budget compared to the initial budget plan is the collection of VAT, namely by over 40 billion dinars. The reason for this change has been the low collection of VAT since the beginning of 2023. This decline is particularly surprising considering that inflation has exceeded expectations in 2023, which should have led to higher VAT collection compared to the plan. Therefore, for a given level of consumption, the tax administration of Serbia has failed to collect the same amount of VAT revenue this year as in the previous few years. This negative outcome is actually not too much of a surprise considering the long-term depletion of human resources in the Tax Administration. That is why the tax administration is obviously no longer able to deal with VAT evasion attempts as effectively as in previous years (which are probably even more pronounced now with the economic slowdown). The Fiscal Council has been warning the Government for a long time about the serious problem of the lack of employees in the Tax Administration (without denying the progress made over the previous years due to digitalization and technical equipment in this institution). The number of tax inspectors and employees in the administration of this institution is far less compared to comparable countries, with a worse age structure and a tendency toward constant deterioration. That is why the drop in VAT collection in 2023 is a clear warning and a call to the Government to finally tackle this problem, i.e., strengthen the human resources available to the Tax Administration because it is one of the most important institutions for the successful operation of the entire public finance system.

The proposed Supplementary Budget suffers from the usual lack of transparency. As in previous years, the new Supplementary Budget does not provide the necessary explanations for relevant changes in the structure of budget expenditures. For example, it does not explain why the transfers to the City of Belgrade for the subway construction are eight times reduced compared to the initial budget plan (from 30 to 4 billion dinars). The reason behind the reduction in state expenditures for expropriation by about 30% (from 18.6 to 13.2 billion dinars) is not stated either, i.e., the specific projects that are delayed and the reasons for such a delay. On the other hand, it is not explained why the costs of building sports stadiums have now increased by approximately 5 billion dinars. The 60% increase in subsidies to road companies (from less than 20 to almost 32 billion dinars) remains unexplained. This increase should be explained, especially considering that some representatives of the Government (the former Ministry of Construction, Transport, and Infrastructure) pointed out the problems in the operations of these companies. For one rather important state program, i.e., the protection of energy-vulnerable households, the funds were cut in half by the Supplementary Budget (from 4 to 2 billion dinars). We believe that an explanation is needed as to why this significant program is being unsuccessfully implemented. Budget allocations for JP Resavica are increasing, even though the Government stated three years ago (in the Fiscal Strategy) that it defined an action plan with the support of the World Bank to resolve the fate of this company and consequently reduce the budget costs (closing economically unsustainable mines, rationalizing the number of employees, etc.).