Republic of Serbia

FISCAL COUNCIL

NOTES TO THE OPINION ON THE DRAFT FISCAL STRATEGY FOR 2024 WITH FORECASTS FOR 2025 AND 2026

9 June 2023

THE FISCAL COUNCIL IS OPPOSED TO UNSYSTEMATIC AND WASTEFUL PUBLIC FINANCE MANAGEMENT

The Draft Fiscal Strategy for 2024 with Forecasts for 2025 and 2026 was submitted to the Fiscal Council for opinion on 19 May 2023. The Fiscal Council, acting in accordance with its statutory obligations and time limits, prepared and submitted the said Opinion to the Government and the National Assembly on 31 May 2023, as required by the regular budget procedure. After that, the Fiscal Council has a statutory obligation to make the Opinion on the Draft Fiscal Strategy publicly available. However, prior to the publication of this document by the Fiscal Council, public officials announced new, large-scale and unplanned changes in fiscal policy. For this reason, the Fiscal Council, deviating from the standard practice, has supplemented the Opinion on the Fiscal Strategy with notes related to these latest changes.

Public officials announced significant fiscal policy changes outside of the standard budget procedure and plans presented in the Strategy. After the Fiscal Council had completed its analysis of the Draft Fiscal Strategy and sent the relevant Opinion to the Government, the highest-ranking public officials presented completely new, fiscally important, policy measures at the press conference held on 7 June 2023. These measures include:

1) An extraordinary pension increase of 5.5% from October 2023 (on top of the scheduled statutory indexation that will come into force on 1 January 2024).

2) An extraordinary salary increase of 5.5% for part of public sector employees from September 2023. This salary increase applies to a part of employees in education (preschool, primary, secondary education, residence halls for pupils and students) and a part of employees in healthcare (nurses, medical technicians, carers in social welfare homes) - about 200,000 people in total. Moreover, a possibility was also announced to move forward the scheduled annual indexation of their salaries (which will amount to about 10%) - from January 2024 to December 2023.

3) Payment of RSD 10,000 for each child under the age of 16 (about 1.1 million children), which should be effected on 25 September 2023. The money will be paid to mothers or single fathers.

In addition to the above changes, which are the most important and the largest, some fiscally less generous measures were also announced, such as the issuance of additional 100,000 vouchers for tourism, government interventions in the bakery products market, etc. Common to all these measures is that none of them was provided for by the Draft Fiscal Strategy on which the Fiscal Council gave its Opinion. Since these measures significantly change the Government's planned fiscal policy, some of the assessments made by the Fiscal Council in its Opinion will also change.

The first fundamental problem with the new measures is related to the fact that the pursuance of fiscal policy is moved out of the regulated system of public finance management. Conducting fiscal policy "from one day to the next" based on discretionary decisions of public officials has amounted to a very serious problem of Serbia's public finances. Such measures are not in the spirit of domestic legislation, which clearly recognizes the need to conduct fiscal policy in a responsible, predictable and prudent manner. Namely, the law stipulates that the Government is to formulate its fiscal policy in a three-year strategic plan for public finance management (Fiscal Strategy). The Strategy presents the main medium-term fiscal goals of the state (public debt, fiscal deficit, the composition of public revenues and expenditures, etc.), as well as the most important economic policies aligned with those goals. Then, under the budget procedure, the annual Budget Law is to be drafted based on the Fiscal Strategy, which constitutes the main legal framework for the operational conduct of fiscal policy. Through this entire process, the competences of the independent public institution (Fiscal Council), which has the obligation to analyze and assess official plans of the Government and to inform the National Assembly and the general public accordingly, are precisely defined. The purpose of all these procedures is for them to ensure that the fiscal policy is based on in-dept analyses of the most important needs of society, and that public finances are then guided in a controlled manner so as to respond to those needs in the best possible way. If these procedures are not followed, the risk of putting into place inappropriate fiscal policy measures will increase. This is exactly the case with the most recent measures, which were not provided for by the Fiscal Strategy for 2023, or by the 2023 Annual Budget Law, and they are not included even in the Government's fiscal plans that were prepared less than three weeks ago (the draft of the new Fiscal Strategy). These measures not only make the budget process basically pointless but are also very dubitable from the economic standpoint.

The extraordinary increase in pensions violates the applicable fiscal rules that clearly and responsibly regulate this area, which is economically very dangerous. Probably the most problematic of all the new measures is the extraordinary pension increase of 5.5%. Although the amount of this extraordinary increase in pensions does not have the weight to directly threaten the stability of public finances, this increase is very dangerous from the standpoint of principle and therefore unacceptable. Because of their amount, pensions are crucial for the sustainability of Serbia's public finances (along with salaries in the public sector). For that reason, increases in pensions must not be determined arbitrarily – instead, this should only be done on the basis of objective economic parameters that take into account the capacity of the domestic economy to finance them. This is also recognized in Serbia's law and very clearly and economically soundly defined. More specifically, Serbia, like other organized countries, has in its legislation precisely defined rules for pension indexation (fiscal rules). These rules, however, are grossly violated by this extraordinary increase in pensions. The citizens of Serbia felt in the not-so-distant past how dangerous it can be to violate the objective rules on pension increases - when in late 2014, as part of fiscal consolidation, their (inevitable) reduction had to occur followed by subsequent very modest increases. Serbia is currently still very far from repeating the same scenario, but it is not reasonable to take the wrong direction of arbitrarily increasing pensions again - especially since very good rules for their regular indexation are now in place.

An extraordinary increase in salaries in certain segments of the public sector adds to the messy situation in the inadequate system of wages and salaries in the public sector. One of the biggest and most persistent problems of Serbia's public finances is the unregulated system of wages and employment in the public sector. Despite the fact that on a number of occasions during the previous decade, the Government announced that it would solve this problem by introducing a uniform system of pay grades and precisely defining the required number of employees in all segments of the public sector - none of the above was implemented. Instead of such systemic and sustainable solution, the practice is repeated year in, year out of adopting higher salary increases for certain parts of the public sector (usually the army, police, healthcare) than for others - without any objective analysis or criteria. Now the time has come to reward the employees in parts of the education and health sectors with extraordinary salary increases, but again, it is not known exactly on what basis the Government made such a decision. After many years of neglecting education and healthcare sectors, they undeniably deserve special attention, but a resolution to the problems of employment and wages in these large and important sectors requires a systematic approach. One of the bad examples illustrating the consequences of an unsystematic approach to the resolution of these problems is the Tax

Administration, which already has major problems due to a shortage of human resources that threatens to undermine the efficient collection of public revenues (see the chapter on the Tax Administration).

Another round of untargeted distribution of money to citizens is a very economically harmful and socially irresponsible policy. There is no doubt that Serbia needs a reform aimed at increasing the coverage and expenditures for social protection - especially since the extremely high rise in food and energy prices threatens the most destitute citizens of Serbia in particular (see the chapter on social policy). However, instead of taking a serious, thorough and responsible approach to the problems of the most socially vulnerable citizens of Serbia, the Government has once again announced a one-off payment, this time, to all children under the age of 16 - without examining whether they objectively need this type of assistance or not. The Fiscal Council has already shown on countless occasions how irrational and wrong such measures involving untargeted distribution of money to citizens are, which is why they should not be part of the official social policy in Serbia under any circumstances. We want to draw special attention this time to the fact that this type of measure is particularly detrimental in the current macroeconomic environment. More specifically, the biggest macroeconomic problem in Serbia at the moment is high inflation (coupled with sluggish economic growth). In this regard, the untargeted distribution of money to the citizens of Serbia can add fuel to the fire of high inflation, while lacking the capacity to accelerate economic growth. What is worse, fueling price hikes by inadequate fiscal policies could further undermine the living standards of Serbia's poorest citizens – hence, this measure could easily prove to be even counterproductive from the standpoint of social policy.

We estimate the total cost of the new measures at around EUR 550 million that is not financed from surpluses but rather by government borrowing (on very unfavorable terms). The extraordinary pension raise of 5.5% will permanently increase the budget pension expenditure by around EUR 350 million on an annual basis, and this is fiscally by far the largest and most important measure. A one-off payment of RSD 10,000 for children under the age of 16 will cost around EUR 100 million, while the extraordinary rise in salaries in part of the public sector will increase the annual budget expenditure for salaries by around EUR 80 million (on a net basis). The remaining new fiscal policy measures (vouchers for tourism, etc.) will cost around EUR 20 million in total. Most of these new expenditures will only show in the 2024 budget (since extraordinary increases in pensions and salaries are planned for late 2023), while the 2023 budget will be burdened the most by one-off grants for children. Since Serbia’s budget has been running a deficit for quite some time now, i.e., there are no surpluses that can be used to fund new policies, all the measures will be financed exclusively by government borrowing. This borrowing is one of the important negative aspects of the new wasteful measures, and an additional reason why the Fiscal Council has assessed them as unwarranted and unnecessary. This assessment is supported by the fact that the government is currently borrowing on the financial market at a high interest rate of around 6.5% (which reaches around 8% in the case of some of the recent loans with a variable interest rate). By introducing the new measures, a good opportunity was missed in all likelihood to reduce Serbia's fiscal deficit to around 2% of GDP or less in 2023, and to below 1.5% of GDP in 2024, which could have substantially decelerated government borrowing.

The Fiscal Council, in its Opinion on the Draft Fiscal Strategy, recommends to the Government such fiscal policies that are essentially opposite to those that have been announced now. Despite the fact that, with its new fiscal policy measures, the Government has rendered the Draft Fiscal Strategy, on which the Fiscal Council issued an Opinion, largely senseless - the recommendations of the Fiscal Council set out in this Opinion are still more than relevant. In fact, all the arguments that prompted us to propose a cut in the fiscal deficit, the launch of the reform of the social protection, healthcare and education systems, the strengthening of human resources in the Tax Administration; that prompted us to support the predictable and consistent indexation of pensions and salaries in the public sector based on fiscal rules, etc. - are now gaining on importance, bearing in mind the recent measures adopted by the Government.