Republic of Serbia

FISCAL COUNCIL **31 May 2023**

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

Summary

The Draft Fiscal Strategy provides for a modest improvement of fiscal policy in the coming years. The Draft 2024 Fiscal Strategy with Forecasts for 2025 and 2026 confirms the intention of the Government to gradually progress towards balancing public finances over the medium term. Pursuant to the Strategy targets, the fiscal deficit should decline from 3% of GDP in 2023 to 2.2% of GDP in 2024, and then to 1.5% of GDP in 2025. Thereafter, the identical deficit level of 1.5% of GDP would be kept in 2026. The Strategy also envisages a decline in the public debt-to-GDP ratio from 55.6% (at end-2022) to 51.9% at end-2026. This course in fiscal policy is undeniably good; however, the Fiscal Council assesses that the Strategy could and should have foreseen a more ambitious balancing of public finances. The reform-related section of the Strategy does not adequately recognize all important policies that would improve public finances, as well as the quality of life for a large number of Serbian citizens. Thus, the Strategy does not recognize that a more generous and efficient social policy is needed, in particular because the surge in food and energy prices strongly undermines the living standards of the poorest segments of Serbia's population (instead, the plan is to reduce expenditures for social benefits as a share in GDP). No appropriate solution is offered to regulate the inadequate system of wages and employment in the public sector, which threatens to obstruct the performance of important functions of the state (in this Opinion, we have devoted special attention to the Tax Administration). The necessary reforms are also lacking – of the taxation, health care and education systems, selection and management of public investments, etc. Regarding public utility companies in the energy sector (EPS and Srbijagas), the Strategy is making a step forward, because the responsibility for their problems is no longer only attributed to the global energy crisis; instead, more serious reforms and investments in these companies are announced. Nonetheless, more concrete plans for that are still under construction.

The planned narrowing of the fiscal deficit should be considerably stronger than what is foreseen by the Strategy. As mentioned before, there was a good opportunity for a stronger cut in the fiscal deficit and a faster decline in the share of public debt in GDP than what is foreseen by the Strategy, but it was missed. The best way to demonstrate this is to analyze the fiscal deficit in the previous year, in 2022. Specifically, in the 2022 deficit outturn of 3.2% of GDP (EUR 1.9 billion), about 2.7% of GDP was the result of covering the losses of public utility companies from the energy sector, while the remaining main budget flows were almost balanced (a deficit of 0.5% of GDP). Turning now to 2023, it is obvious that the losses of EPS and Srbijagas will be significantly lower than in 2022 (lower energy prices on the global market, milder winter, higher production in EPS, full gas storage facilities) – for which reason this main portion of the deficit should be significantly reduced. The remainder of the deficit should not change much compared to 2022, because along with some new liabilities, certain

burdensome spending has also been eliminated (e.g., one-off and untargeted grants for young people, whose cost to the budget in 2022 was more than EUR 250 million, have been justifiably eliminated). Consequently, it remains unclear why the Strategy only plans a minimal cut of the 2023 fiscal deficit (from 3.2% of GDP in 2022 to 3% of GDP in 2023), and then this overly wide deficit is further used as a base for the gradual balancing of public finances in the coming years.

The Fiscal Council therefore recommends to the Government to cut the budget deficit to around 2% of GDP in 2023 (instead of 3% of GDP), and to 1.5-1% of GDP in the subsequent years. Such a change in the plan compared to the Strategy would be advantageous for Serbia in many ways. First of all, with a lower fiscal deficit (as proposed by the Fiscal Council), the public debt at end-2026 would be lower by as much as EUR 2 billion compared to the current plan in the Strategy, which would consequently result in tangibly lower annual expenses for interest payments (approximately EUR 100 million). A sharper-than-planned narrowing of the deficit would also contribute to the reduction of the country risk from the point of view of investors, which would in turn lead to a reduction in the interest rates on not only government borrowing, but also private sector borrowing. Finally, another important reason why the opportunity to reduce the fiscal deficit more sharply should be seized is related to the fact that this type of economic policy has a disinflationary effect, and high inflation is probably the biggest macroeconomic problem of Serbia right now. Concrete items where we see room for substantial savings in the budget include first of all: net lending (net budget loans), purchases of goods and services, and interest expenses; however, savings are necessary and possible on other budget items as well.

A cut in the planned deficit also narrows down the space for the adoption of new and harmful *ad hoc* measures, which is also very important. A detrimental practice from previous years was that the budget was initially planned too generously, and then this space was used in the course of the year to introduce a large number of insufficiently well-designed, *ad hoc* measures. These measures often involved untargeted and across-the-board payments to specific population segments, which is both economically and socially unjustified - and sometimes the funds were spent on attempts to deal with real and serious problems of the country. However, this is not how public finances should be managed. *Ad hoc* policies that did not result from in-depth analyses can only be a rare exception in fiscal policy, and by no means a rule (as is currently the case in Serbia). The reason for this is related to the fact that such measures are usually insufficiently efficient and costly, and consequently do not have the capacity to permanently solve the problems for whose resolution they were designed. In this connection, the generously planned deficits in the Strategy for 2023 and the following years open up too much space for the Government to continue with pursuing fiscal policy "on the fly" and in an unsystematic manner, which should be curbed by such strategic documents, rather than encouraged.

The Strategy has not at all recognized the problems in the agricultural sector, which in the meantime have already been "remedied" by a steep increase in subsidies. A very illustrative example of unsystematic, *ad hoc*, fiscal policy pursuance is the recently adopted generous increase in direct payments to agriculture. This increase was not planned in the 2023 budget, and in the Draft Strategy, on which we are giving an Opinion at this point in time, the problems in agriculture were not even mentioned. Therefore, one can clearly see here some of the fundamental weaknesses in the conduct of fiscal policy in Serbia. More specifically, serious problems in the agricultural sector have persisted for quite some time now. In the last few years, the prices of production inputs have risen sharply, and the Government, pressured by other problems, adopted certain measures at the same time, which have placed an additional burden on agriculture (the ban on exports of certain agricultural products during 2022 and part of 2023, an overly long freeze on the selling prices of basic foodstuffs in order to curb inflation).

Frequent protests by farmers in the course of 2022 were a clear signal that agricultural policies needed to be enhanced. However, instead of recognizing this problem back then and coming up with appropriate solutions after a thorough analysis, which would be incorporated into the official policies and documents of the Government (the Fiscal Strategy and the 2023 Annual Budget) - this did not happen. It was only at end-May 2023 that a forced solution was reached (under the pressure of new protests by farmers), namely in the form of a steep rise in agricultural support, which will cost the budget as much as EUR 360 million. These high expenditures will not directly undermine the 2023 budget (among other things, because other subsidy items are planned too generously), but the problem could have been resolved far more rationally, more prudently for the budget and more efficiently, if only the Government had responded in a timely fashion to clear signals which existed for a prolonged period of time.

There are strong indications that Serbia needs a systematic improvement of social policy, but this has not been recognized in the Fiscal Strategy. In the area of social policy, the Government should not repeat the mistake it made in the case of agriculture. A comparative analysis clearly shows that Serbia's expenditures for social protection are currently too low - they are lower than the average in the countries of Central and Eastern Europe (CEE) by 0.5-1% of GDP (although Serbia is considerably poorer than these countries). Moreover, these budget expenditures are showing a multi-year descending trend as a share in GDP, which will continue according to the forecasts in the Strategy (according to these forecasts, social protection expenditures should drop to a new all-time low of 3.2% of GDP in 2026). On the other hand, the need for support to the most destitute citizens of Serbia is now particularly strong because of their above-average vulnerability to high inflation. In the composition of high inflation, food and energy products, for which Serbia's most deprived citizens set aside the largest portion of their incomes, have seen the biggest price hikes. The growth in the prices of food in the period from early 2021 to May 2023 amounted to almost 50%, and of energy products to about 35% (with the new electricity and gas price hikes that occurred in May not yet being included in this calculation). Because of this structure, inflation for poor citizens of Serbia is substantially higher than the inflation felt by the more affluent, and the current social protection system cannot recognize that. Likewise, the assistance to energy vulnerable households, which has been improved "on paper" as of 2023, has not properly taken root in practice, since many households that are eligible for this assistance are not using it. Therefore, the Fiscal Council calls on the Government not to wait for the problem to escalate further, but to embark upon a systematic reform of the social protection system, which would be aimed at expanding the coverage, increasing the paid amounts and relaxing the criteria for the payment of social benefits. In addition, an important contribution to reducing inequality in Serbia could be made by the tax reform moving in the direction of greater progressivity, but this is not planned in the Strategy either.

An unregulated system of wages and employment in the public sector threatens to call into question the functioning of important segments of the state - in the specific case of the Tax Administration. The hitherto reform of the Tax Administration, which began in 2015, could be assessed as successful for the most part. Within this reform, the management of this institution has been improved, a more streamlined organizational structure has been established (the excessive number of branch offices was reduced), non-core activities have been transferred to other institutions, electronic tax returns have been introduced, etc. The effect of the Tax Administration reform on the higher collection of tax revenues was exceptional, and it was precisely one of the main factors that enabled the successful fiscal consolidation. The analysis of the Fiscal Council, however, shows that the further operation of the Tax Administration is called into question by the shortage of human resources – i.e., insufficient number and poor composition of employees. Currently, the Serbian Tax Administration has one employee per 1,584 inhabitants, while the average of comparable CEE countries stands at around 950 inhabitants. At the same time, the number of employees in the Serbian Tax Administration shows the trend of constant and rapid decline. In 2015, the Tax Administration had a little over 5,200 employees, and in late 2022, that number already dropped to around 3,700. The biggest problem is in the tax inspection, where only about 55% of the approved positions are filled. To all these problems, we should add the fact that almost 50% of employees in the Serbian Tax Administration are older than 55 years of age. The dwindling human resources in the Tax Administration, as well as in some other parts of the public sector, can become a huge problem of Serbia's public finances, and this is not recognized by the Strategy at all. That is why the Fiscal Council is drawing the attention of the Government to the need to make a more concrete effort to strengthen the human resources of the Tax Administration, as well as to systematically regulate salaries and employment in the public sector.

The Strategy finally features some more credible announcements of reforms and investments in public companies in the energy sector, which we consider necessary. The underperformance of unreformed public enterprises in the energy sector (EPS and Srbijagas) was the biggest fiscal problem in the previous two years. The state intervened to cover the losses of these companies in the period from autumn 2021 to May 2023, with as much as EUR 3 billion - of which more than EUR 2.1 billion was direct budget support, and the rest referred to government guarantees on liquidity loans to these companies. Since the very outbreak of the energy crisis, the Fiscal Council has been associating the root causes for these huge costs with domestic rather than international factors. In other words: 1) if EPS had not been severely weakened by many years of mismanagement and lack of investments; 2) if Srbijagas had expanded the existing gas storage facility in a timely fashion and managed it better; and 3) if the Government had not been so late with the much needed increase in the domestic price of gas and electricity - the fiscal costs for these companies would have been much lower (if any at all). The essential change in the new Strategy is that now, for the first time, the "structural, deeply rooted weaknesses of the energy sector" are clearly recognized, instead of shifting the responsibility for all problems to the global energy crisis, as was done before. Furthermore, the first, so far only administrative steps, in improving the management of state-owned enterprises in the energy sector, have been taken. EPS has changed its legal status from a public enterprise to a joint-stock company and the Government has approved the Law on the Management of State-Owned Enterprises (we expect its adoption by the Parliament in the near future). The Fiscal Council supports the Government’s active approach to solving the huge problems of the domestic energy sector, but we also expect the plans for the announced reforms and the necessary investments in EPS and Srbijagas to be more concretely presented in the strategic documents that will follow.