REVIEW PAPER
UDK: 330.34(497.11)
336.02(497.11)
DOI: 10.5937/EKOPRE2302101R
Date of Receipt: January 10, 2023

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# SUSTAINABILITY OF FISCAL FRAMEWORK AND ECONOMIC GROWTH IN SERBIA

## Održivost fiskalnog okvira i privredni rast u Srbiji

## Abstract

In the last three years, Serbia led a very expansionary fiscal policy, with a fiscal deficit higher than the average of the countries of Central and Eastern Europe (CEE)[1] and the Western Balkans[2]. This led to a significant rise in public debt in absolute terms, while public debt-to-GDP ratio increased only slightly, due to the currency structure of debt, the unchanged exchange rate of the dinar against the euro, and high inflation. At the end of 2022, Serbia was the European median in terms of public debt, although the debt was above the average of comparable CEE countries. Despite the moderate level of debt, public interest expenditures and the effective interest rate on Serbia's public debt are relatively high in European terms, which is a consequence of the fact that financial markets in less developed countries see the limit of sustainability of public finances at a lower level of indebtedness than in developed countries. Tightening of monetary policy in the world will trigger the further increase of government spending on interest, which may crowd-out more productive public expenditures or narrow the room for tax cuts, which is why it is especially important to keep the public debt at a lower level in the coming period. At the end of 2022, Serbia implemented a fundamental reform of fiscal rules. The advantage of the new fiscal rules is reflected in a lower deficit target and a more detailed elaboration of the government's response mechanisms to violations of the rules. Raising the public debt ceiling to the upper limit of the prohibitive zone, the elimination of countercyclical elements in the deficit rule and the absence of clear escape clauses for periods of crisis may pose a limitation. The new fiscal rules could contribute to the sustainability of Serbia's fiscal policy, provided that their consistent and continuous application is ensured.

**Keywords:** *fiscal policy, fiscal rules, fiscal framework and economic growth*

## Sažetak

U prethodne tri godine Srbija je vodila vrlo ekspanzivnu fiskalnu politiku, sa fiskalnim deficitom većim od proseka zemalja Centralne i Istočne Evrope (CIE) i Zapadnog Balkana. To je dovelo do znatnog rasta javnog duga u apsolutnom iznosu, ali je odnos javnog duga i BDP-a porastao relativno malo, zbog devizne strukture javnog duga, nepromenjenog kursa dinara prema evru i visoke inflacije. Krajem 2022. godine, Srbija je prema visini javnog duga bila evropska medijana, mada je dug bio iznad proseka uporedivih zemalja CIE. I pored umerenog nivoa duga, javni rashodi na kamate i efektivna kamatna stopa na javni dug Srbije su u evropskim razmerama relativno visoki, što je posledica činjenice da finansijska tržišta u manje razvijenim državama granicu održivosti javnih finansija vide na nižem nivou zaduženosti nego u razvijenim državama. Zatezanje monetarne politike u svetu uticaće na dalje povećanje troškova kamata, koji istiskuju produktivnije javne rashode ili prostor za smanjenje poreza, zbog čega je posebno važno u narednom periodu javni dug držati na nižem nivou. Srbija je krajem 2022. godine izvršila temeljnu reformu fiskalnih pravila. Prednost novih fiskalnih pravila ogleda se u nižem ciljanom deficitu i detaljnijoj razradi mehanizama reagovanja države na kršenje pravila. Podizanje limita javnog duga na gornju granicu prohibitivne zone, eliminacija kontracikličnih elemenata u pravilu vezanom za fiskalni deficit i odsustvo korektivnih mehanizama za krizne periode, mogu predstavljati ograničenja. Nova fiskalna pravila bi mogla da doprinesu održivosti fiskalne politike Srbije, pod uslovom da se obezbedi njihova dosledna i kontinuirana primena.

**Ključne reči:** *fiskalna politika, fiskalna pravila, fiskalni okvir i privredni rast*

1 Bulgaria, Croatia, Czechia, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, Slovenia

2 Albania, Bosnia and Herzegovina, Montenegro and North Macedonia

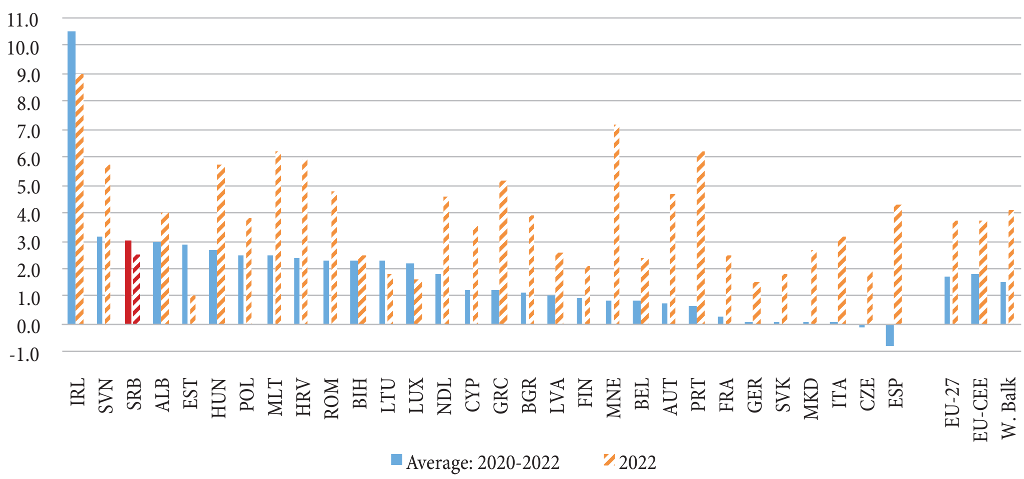
## Introduction: Economic performance of Serbia in the short and long run

In the second half of 2022, there was a noticeable slowdown in economic growth in Serbia. This is a consequence of high inflation, changes in the terms of trade (due to the strong rise in energy prices), the rise in interest rates due to the tightening of monetary policy in an effort to curb inflation, and problems in supply chains that existed in a significant part of the year [12]. In addition to the aforementioned factors that affected economic trends in other European countries as well, the economic activity in 2022 in Serbia was additionally negatively affected by the problems with the business operations of the state-owned companies in the energy sector and the bad agricultural season. Consequently, the 2022 GDP growth rate in Serbia is downgraded to between 2.2 and 2.5 percent. On the demand side, there was a slowdown in all components except for the exports, which continued to grow primarily due to the increase in export prices. On the other hand, viewed from the production side, strongly negative trends in the second half of the year are recorded in agriculture and construction, and the slowdown is also noticeable in other sectors, except in information and telecommunication technologies.

The slowdown in economic growth in 2022 also occurred in other European countries. According to revised estimates, the average GDP growth rate in the EU-27, as well as in the EU countries from Central and Eastern Europe (EU-CEE) in 2022 stood at about 3.8 percent, and in the countries of the Western Balkans about 4.1 percent (Figure 1). The growth of Serbia's economy in 2022 was slower compared to EU member states due to the earlier recovery of Serbia's economy from the pandemic crisis – in 2021 economic growth in Serbia was higher by about 1.5 percentage points compared to the EU and CEE average. Most European countries achieved full economic recovery from the pandemic crisis later – yet in 2022, which is, among other things, a consequence of the longer enforcement of epidemiological restrictions. In addition to that, bad agricultural season and the problems in the energy sector also contributed to weaker growth performance of Serbian economy in 2022.

However, observed at the level of a three-year period, the economy of Serbia has achieved solid results in terms of the average growth rate of GDP, which in the period from 2020 to 2022 averaged about 3 percent per year, while in the EU-27, the EU-CEE and the countries of the Western Balkans, the average annual GDP growth rate was 1.5-1.7 percent per year (Figure 1). Similar results to Serbia in the previous three years were also achieved by Slovakia, Albania, Estonia and Hungary, while almost all other European countries posted lower growth, except Ireland, which posted enormous economic growth during that period due to the development of the export-oriented IT industry. Solid results in terms of economic growth in Serbia in the previous three years are the result of the difference in the structure of the economy (smaller share

**Figure 1: GDP growth rates in Europe, 2020-2022 (%)**




Source: IMF World Economic Outlook Database, Oct 2022 and Ministry of Finance of Serbia

of sectors strongly affected by the pandemic), milder epidemiological measures and very high fiscal and monetary incentives applied in Serbia in the first and second year of the pandemic [14].

Pronounced geopolitical risks associated with the war in Ukraine, as well as uncertainty regarding the further development of the relations between the West and China, and the presence of relatively high inflation will make economic growth in most European countries relatively slow in 2023 as well. Similarly, according to the assessment of international financial institutions, the GDP growth rate in Serbia in 2023 may range between 2 percent and 2.5 percent. Such economic growth would be close to the average of the countries of the Western Balkans, and somewhat higher than the expected growth in the EU countries (Figure 2). Medium-term economic forecasts show that, assuming that there is no significant deterioration in the country's international position, in the period from 2023 to 2025, the average annual GDP growth rate in Serbia could be around 3.3 percent, which is slightly higher than in the Western Balkans countries (3 percent), EU-CEE (2.7 percent), as well as in relation to the EU-27 average (2.2 percent).

Achieving slightly faster economic growth in Serbia in the next three years would lead to a slight economic convergence with European countries in terms of economic development. However, in order to significantly reduce the gap in development, which compared to the EU average amounts to almost 60 percent, and compared to the CEE countries about 40 percent [15], it is necessary for the economy of Serbia to achieve economic growth which would be by 1-2 percentage points faster than in those countries, in a period of a couple of decades. In order to achieve this, along with improving the quality of general business conditions (rule of law, efficiency of administration and fight against corruption), it is necessary to ensure microeconomic and fiscal stability and public finance sustainability in the long term, which is crucially influenced by the nature of fiscal policy [10].

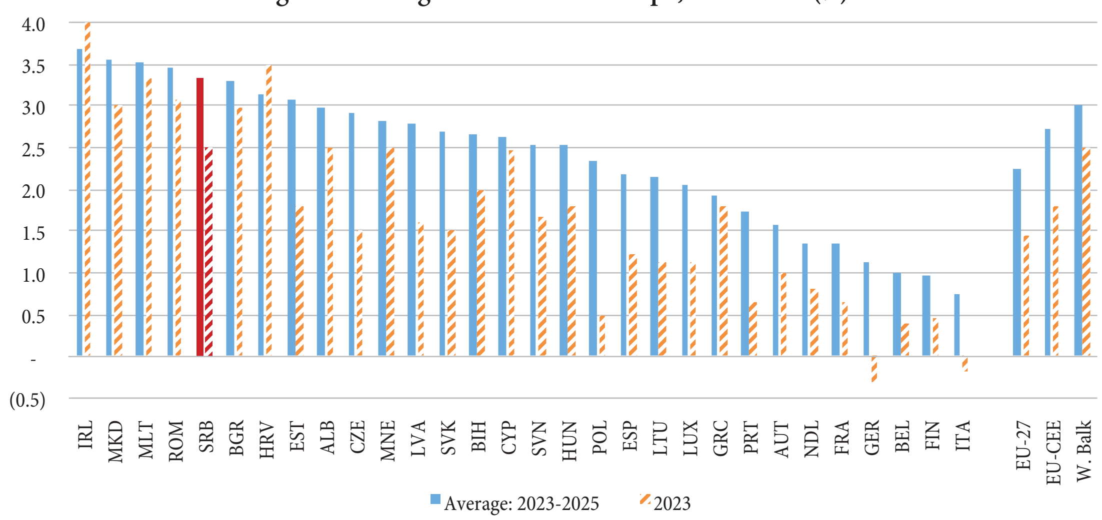
In this regard, this paper analyzes the sustainability of Serbia's fiscal policy, based on three parameters – the dynamics of the actual and structural fiscal deficit, the level of public debt and the relative volume of government spending on interest. In addition, the paper evaluates the reform of fiscal rules in Serbia, as an institutional framework for sustainable fiscal policy.

## Sustainability of general fiscal framework of Serbia: Stylized facts

### Fiscal balance

The fiscal balance is a basic indicator of the fiscal stance of a country, because its level affects the dynamics of the public debt, the need for financing, as well as the total domestic demand. Serbia entered the period of the pandemic crisis with a solid fiscal balance. In the period 2017-2019 on average, Serbia posted a consolidated fiscal surplus of around 0.5 percent of GDP. Similarly, most EU countries

**Figure 2: GDP growth rates in Europe, 2023-2025 (%)**




Source: IMF World Economic Outlook Database, Oct 2022 and Ministry of Finance of Serbia

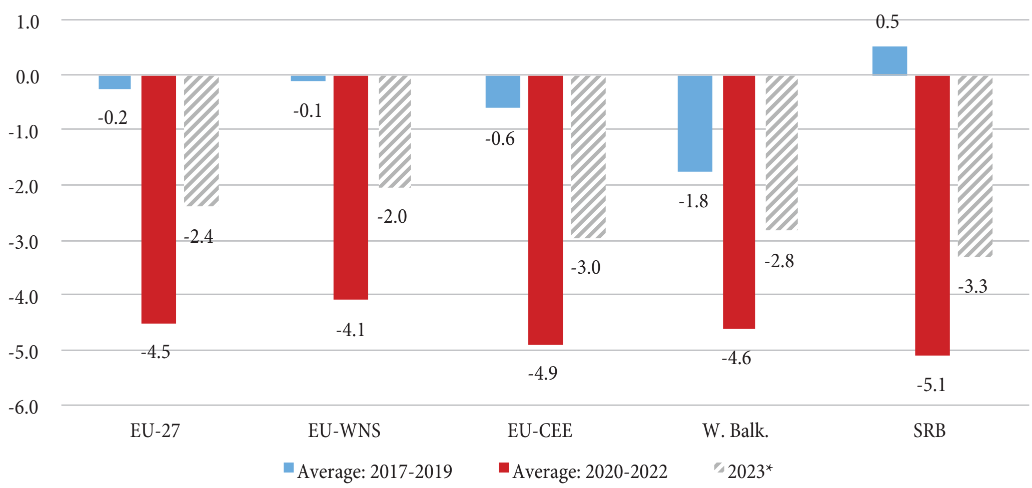
entered the pandemic period with a low fiscal deficit, while in the Western Balkans countries, pre-pandemic fiscal deficit was moderate (Figure 3). After that, in the period of the COVID-19 pandemic, there was a surge in the fiscal deficit in all European countries, primarily due to large fiscal stimuli [11], and to a certain extent also due to the automatic decline in tax revenues caused by the slowdown in economic activity.

In the period from 2020 to 2022, Serbia posted a high fiscal deficit of about 5.1 percent per year on average, which was higher compared to the average deficit in the EU-27 countries, as well as to the old member states from Western, Northern and Southern Europe (EU-WNS), and in relation to the EU-CEE countries and the countries of the Western Balkans (Figure 3). Bearing in mind that in this period the average GDP growth in Serbia was above the average of these countries, it is concluded that the high fiscal deficit was predominantly a consequence of discretionary fiscal policy measures, some of which were economically justified (support to the economy in the first and second year of the pandemic), while some were not (non-means tested payment of financial aid to citizens regardless of financial situation), while some measures were economically and politically forced (e.g. subsidies for energy sector).

Serbia entered the new wave of the global crisis, caused by the war in Ukraine, with a relatively high fiscal deficit, which, together with other factors related to the doctrine of fiscal policy, influenced the expected fiscal deficit in Serbia to be higher in 2023 than in most other European countries (Figures 3). The presented data suggest that after the fiscal expansion during the pandemic, developed European countries (EU-WNS) managed to halve their fiscal deficits, while the less developed countries – the EU-CEE, the Western Balkans, as well as Serbia, continued with the very expansionary fiscal policy. The difference regarding the dynamics of the fiscal balance in developed and other European countries can be explained by subjective factors related to the differences in the level of institutional development, as well as by objective circumstances, since the countries of Central, Eastern and South-eastern Europe are in some segments more affected by the effects of the Ukrainian crisis.

The actual fiscal balance is a consequence of the design of the fiscal policy, as well as the general trends in economic activity. In case of strong economic growth or an increase in imports, tax revenues automatically increase, as a result of which the fiscal deficit decreases (or the fiscal surplus increases) and *vice versa*. Therefore, in addition to the actual one, the structural fiscal balance is used to assess the country's fiscal position. Structural fiscal balance refers to cyclically adjusted budget balance, adjusted for non-structural – temporary and/or one-off revenue and expenditure items. Structural fiscal balance shows what the fiscal balance would be if GDP grew at the natural rate and there were no extraordinary one-off factors. In some cases, structural fiscal balance also takes into account adjustments related to absorption (see: [1]).

**Figure 3: Fiscal balance in Europe, 2020-2023 (% GDP)**




Source: IMF World Economic Outlook Database, Oct 2022 and Ministry of Finance of Serbia

The data shown in Figure 4 indicate that Serbia entered the pandemic period with a structural fiscal surplus, which during the pandemic deteriorated into a relatively large structural deficit – close to the EU-CEE average, and significantly higher than the average of developed EU countries. Although a relatively high real fiscal deficit is planned in Serbia in 2023, the structural fiscal deficit has been significantly reduced compared to previous years and should amount to around 1.1 percent of potential GDP, which can be considered a sustainable level. This is a consequence of the fact that a significant part of the actual deficit in Serbia in 2023 is to large extent the consequence of extraordinary expenditures for the energy sector (about 1.5 percent of GDP), and slower growth of the economy than the natural growth rate (which will affect the reduction of tax revenues for 0.7-0.8 percent of GDP).

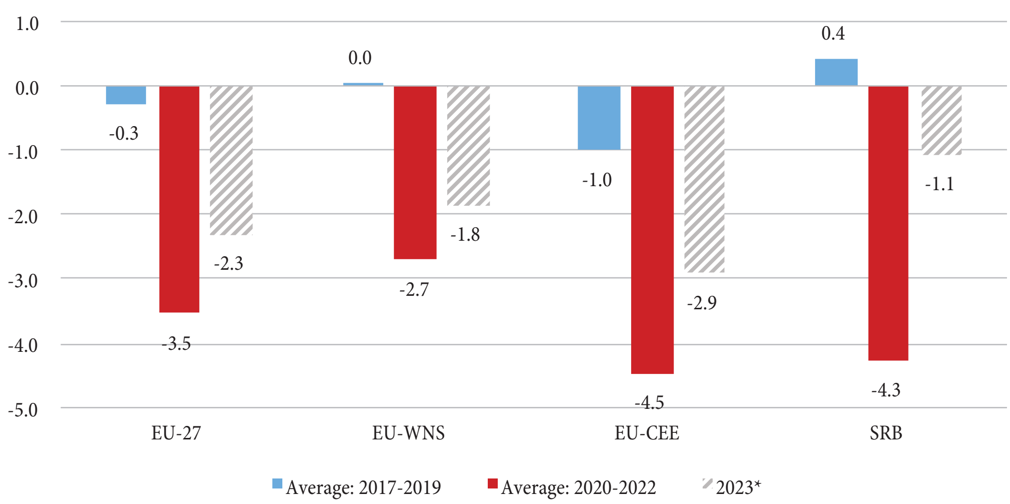
## Public debt

Consolidated general government (gross) debt is considered one of the key indicators of public finance sustainability and prudence of country's fiscal policy. Raising the public debt up to a certain level, for the purpose of financing productive spending (e.g. in infrastructure, human capital, research) may have a positive impact on economic growth [2], [16]. However, raising the debt above the sustainability threshold (entering the prohibitive zone) triggers adverse impact on economic growth, primarily due to surge in country risk and interest rates. Empirical studies show that this threshold of public debt is rising in the level of development of the country. [2] found that in the Euro Area countries, rise of public debt above the 95 percent of GDP threshold has negative impact on economic activity. Consistently, [9] showed that public debt threshold in Central Europe is at around 82 percent of GDP, in Eastern Europe being around 72 percent of GDP, while in the Western Balkans countries at around 58 percent of GDP. At the same time, [13] found that prohibitive zone of public debt in developing countries is around 45 percent of GDP.

At the end of 2022 public debt of Serbia stood at around 55 percent of GDP, which is close to European median and the mean for the Western Balkans countries, albeit considerably higher than in the EU-CEE countries (Figure 5). Serbia was running large fiscal deficits in the last three years (Figure 3) that were on average larger than in most other European countries, which is why total public debt rose by as much as EUR 9.4 billion.

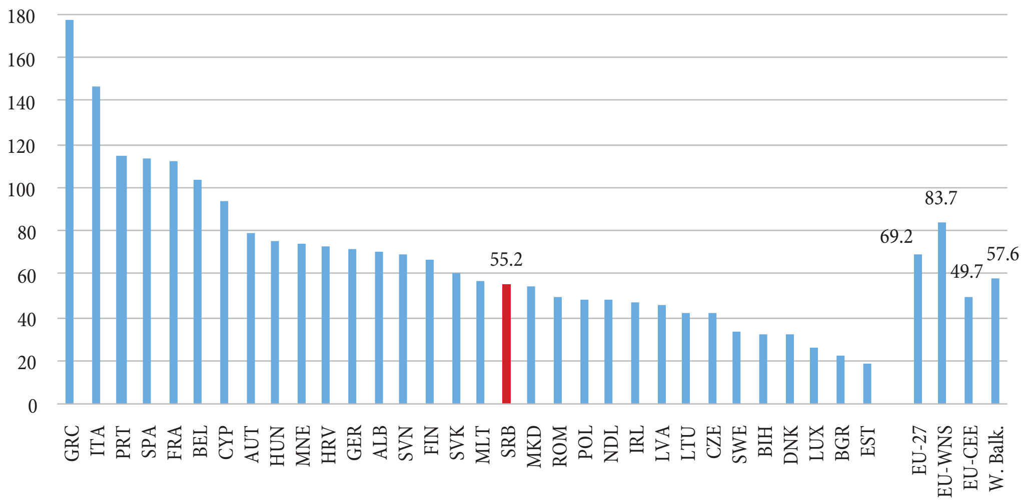
However, rise of public-debt-to-GDP ratio in Serbia over that period was relatively mild and smaller than in other European countries (Figure 6). Inconsistent dynamics of absolute and relative amount of public debt in Serbia over the past three years is the consequence of currency structure of public debt, exchange rate dynamics and inflation. Namely, due to real growth (of more than 9 percent) and high cumulative inflation, Serbia's nominal GDP rose by almost 29 percent in the period 2020-2022. On the other hand, exchange rate of Serbian dinar to Euro was nominally unchanged over that period. Since debt denominated in euro and dinars accounts for close to 70

**Figure 4: Structural fiscal balance in Europe, 2017-2023 (% potential GDP)**




Source: IMF World Economic Outlook Database, Oct 2022

Figure 5: Public Debt in Europe, the end of 2022 (% GDP)




Source: IMF World Economic Outlook Database, Oct 2022 and Ministry of Finance of Serbia

percent of the total public debt, unchanged exchange rate with high inflation had a significant dampening impact on the debt-to-GDP ratio.

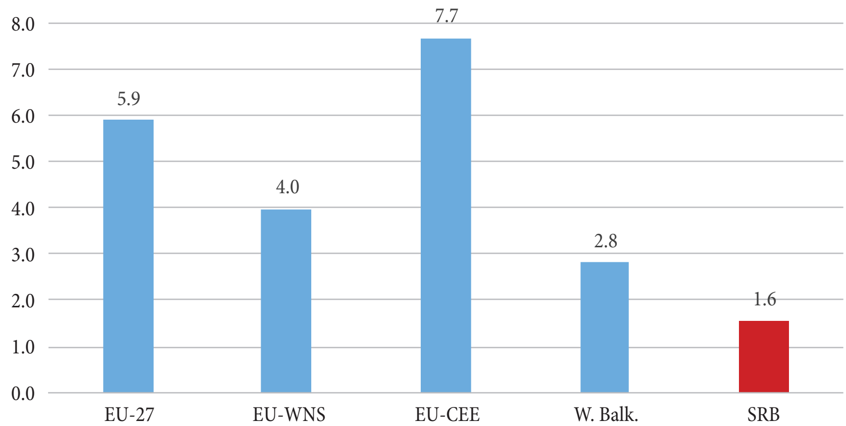
Although public debt in Serbia is within the empirically estimated thresholds, under which debt has no significant impeding impact on economic growth, from the fiscal sustainability and macroeconomic point of view it would be beneficial to keep the public debt substantially below the upper bound of the threshold, which is the case in many EU-CEE countries.

## Government spending on interest

The auxiliary indicator for monitoring and assessment of sustainability of fiscal policy is the volume of government spending on interest, stated relative to GDP or in the form of the effective interest rate, calculated as the ratio of the interest spending and the level of public debt. Relationship between the interest spending and the level of public debt is not linear, since the volume of interest spending also depends on the level of interest rates that are a function of country risks and the general conditions at the capital markets. The volume of interest expenditures and the effective interest rate indicate the crowding-out effect of public debt on other spending items (e.g. public investment or social welfare programs) or on reduction of fiscal space for tax cuts. At the same time, these indicators signal the confidence of the financial markets in long-run sustainability of country's fiscal stance.

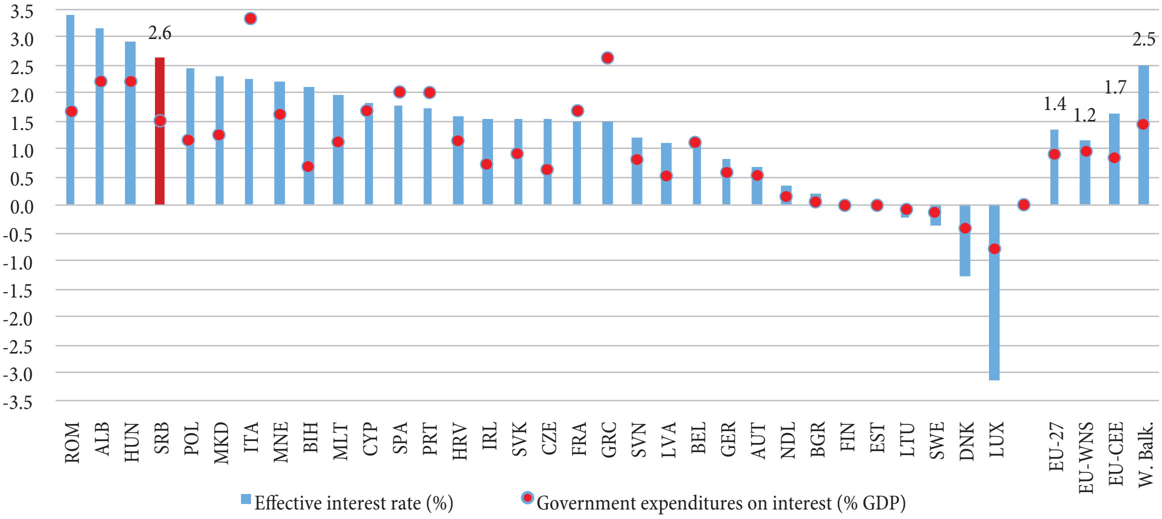
Government spending on interest in Serbia peaked at 3 percent of GDP in 2015. Since then, due to successful implementation of fiscal consolidation, fall and then stabilization of public debt and very favourable general

Figure 6: Change in public debt in Europe  from the end 2019 to the end 2022 (% GDP)




Source: Author's calculations

**Figure 7: Government spending on interest (% GDP) and effective interest rate (%) in 2022**

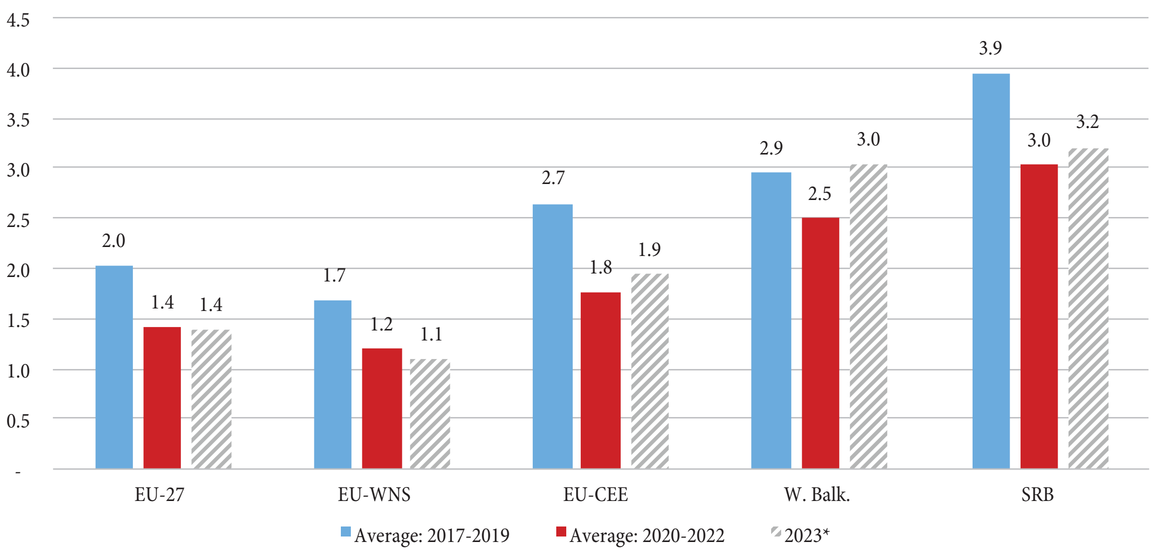



Source: Author's calculations based on the IMF and Ministry of Finance data

conditions at the international financial markets, interest outlays of government in Serbia were on decline. By 2022 government spending on interest in Serbia halved – to 1.5 percent of GDP. Although on decline, relative volume of government spending on interest in Serbia in 2022 stood close to the Western Balkans average, at the same time being almost twofold higher than the EU-CEE average (Figure 7). In other words, if Serbia posted interest expenditures close to the average in other CEE countries, it would save around 0.7 percent of GDP per year, which could be directed into public infrastructure, social welfare programs or reduction in social security contributions rate by close to 2 percent points.

Posting relatively high interest outlays even with a moderate level of public debt indicates that the effective interest rate on public debt is relatively high. Although Serbia is European median in terms of the relative volume of public debt, it ranks among a few European countries with the highest effective interest rate on its public debt, with only three European countries (Romania, Albania and Hungary) paying higher effective interest rates (Figure 7). Level of effective interest rates only to some extent depends directly on the relative volume of public debt, with the correlation the level of debt and the effective interest rates in Europe being only 0.36. This can also be observed from the data presented in Figure

**Figure 8: Effective interest rates by sub-periods (%)**




Source: Author's calculations based on the IMF and Ministry of Finance data

7, which show that at the lower part of the distribution in terms of the effective interest rates are mostly developed European countries, with substantial level of public debt. This means that also other factors, beyond the level of public debt, such as the level of economic development, political stability, confidence in the long-run economic performance, play substantial role in shaping the market confidence in fiscal sustainability of a country. In general, investors start charging additional risk premium yet at lower level of public debt in case of developing countries in comparison with developed countries.

One of the enablers of strong fiscal expansion in Europe over the last few years was linked to very favourable conditions at the financial markets, caused by the buoyant monetary expansion in many countries. Data presented in Figure 8 show that the effective interest rate in all European countries in the period 2020-2022 was substantially lower (in EU-27 by 0.6 percentage points - on average) than in the last three years before the pandemic, although public debt in Europe surged by almost 6 percent of GDP in that period (Figure 6). This was also the case with Serbia that was paying the effective interest rate of 3 percent on average during the period 2020-2022, which was by 0.9 percentage points less than in the period 2017-2019. However, date presented at Figure 8 also show that the effective interest rate in Serbia in the last three years was considerably higher than that in the Western Balkans and EU-CEE, while being double in comparison to the EU-27 average. Part of that interest premium in Serbia is connected to high interest payable on borrowing in the period before successful implementation of fiscal consolidation, while one part reflects the confidence of investors in long-term economic viability and political stability of the country, connected to the level of development.

Due to high inflation, central banks started monetary tightening in 2022 and that process is expected to continue in the time to come. Consequently, financial markets saw substantial rise in the interest rates, which will probably continue throughout 2023. This means that even with the similar level of public debt, countries will be paying higher interests. Data shown in Figure 8 indicate that Serbia, alongside the EU-CEE and the Western Balkans countries is expected to post rise in the effective interest rates in 2023. On the other hand, the effective interest rates in the EU-WNS countries are expected to slightly decline, which may be connected with the fact that these countries will post considerably smaller fiscal deficit in 2023 than Serbia and other countries from the CEE and Western Balkans region (Figure 3).

## Fiscal rules: Institutional framework for sound fiscal policy

### Fiscal rules: Stylized facts and impact

In contrast to monetary policy, which has been for decades conducted based on the pre-defined rules, implemented by independent central, according to pre-defined rules, fiscal policy is still largely discretionary, because it entails direct redistribution of resources in society, which should to be done in accordance with voter preferences. Nevertheless, in order to reduce the possibilities for fiscal profligacy and abuse of fiscal policy, especially in election cycles, to ensure a fair intergenerational distribution of costs and benefits from government intervention and thereby increase the chances of conducting a sustainable and stable fiscal policy, in the last few decades, countries have begun to introduce fiscal rules, i.e. restrictions on fiscal policy, by law or constitution. Fiscal rules can be procedural or numerical - which introduce quantitative limits on the amount of public debt, fiscal balance, public revenues or public expenditures. From the perspective of the level at which they are introduced, fiscal rules can be national or supranational.

From 1985, when they were first created, until 2021, fiscal rules have been introduced in 105 countries. In about half of these countries there are only national rules, while in the other half of the countries there are national and supranational rules or only supranational rules [6]. In over 50 countries that have introduced fiscal rules, the fiscal council was formed, as a body responsible for monitoring compliance with fiscal rules. A large number of countries simultaneously apply several fiscal rules, so that on average these countries apply three fiscal rules. According to the IMF data, fiscal rules limiting the fiscal balance are applied in over 90 percent of countries, fiscal rules limiting public debt are applied in about 80 percent of countries, while fiscal rules ceiling government expenditures or government revenues have been introduced by one half and one sixth of the total number of countries, respectively. Observed by groups of countries, it can be seen that fiscal rules related to government expenditures and the fiscal balance are more prevalent in developed countries, while restrictions on public debt or public revenues are more prevalent in developing countries. It is also observed that developed countries are more prone then developing countries to take into account adjustments related to business cycles, in the design of their fiscal balance rule [6]. In the last decade and a half, a large number of countries have initiated the reform of fiscal rules with the aim of improving their flexibility by means of the escape clause, through the precise definition of conditions and mechanisms for temporary deviation from the fiscal limits in extraordinary circumstances, which creates so called "the second generation of fiscal rules".

The crisis caused by the COVID-19 pandemic required an extraordinarily strong fiscal response from governments, which posed a major challenge for the consistent application of fiscal rules. Therefore, since the breakdown of pandemic, around 80 countries started adjusting fiscal rules through: a) activation of the escape clause (30 countries), b) temporary suspension of the application of fiscal rules (20 countries), c) changing the limits defined by fiscal rules (about 20 countries), d) fundamental revision of fiscal rules (performed or planned to be performed by over 40 countries) [6].

Recent empirical literature ([5], [6]) indicates that the existence of fiscal rules affects the reduction of the fiscal deficit and public debt. [4] showed that 3 percent deficit rule set-out by the Maastricht criteria, acts as a "magnet" – since introduction of the rule, the number of countries with the deficit around the threshold has been rising by 20 percent, while the occurrence of both large government deficits and surpluses being on decline. In addition to that, studies [8] also show that the national fiscal rules and a conservative budgetary procedures scale-down the magnitude of political budget cycles in low-income countries. Empirical literature also indicates that numerical rules are often associated with low compliance, while improving flexibility of fiscal rules to make them more responsive to shocks raises their complexity [3].

## Evaluation of the reform of fiscal rules in Serbia

Fiscal rules were introduced in Serbia in 2010. They consisted of general fiscal rules that impose the limit to the fiscal balance and public debt, and special fiscal rules that introduce limit to the public expenditures on pensions and wages. Thus, the medium-term fiscal deficit target was set at the level of 1 percent of GDP, while the actual target was defined by a formula and deviated from the general one depending on the state of the economy and the inherited deficit of the previous year. In this way, the rule for the fiscal deficit had a strong countercyclical component in line with practice in advanced economies, and it also took into account the existing state of public finances, which made the limit more realistic. On the other hand, the fact that the rule was defined by a formula made it more complex and less comprehensible to the general public. The second part of the general fiscal rule limited the public debt (without liabilities based on restitution) to the amount of up to 45 percent of GDP. Modest ceiling in terms of debt created solid fiscal buffers, but at the same time reduced the chances for compliance of fiscal policy with the restrictive rule. Special fiscal rules defined that the indexation of wages in the public sector and pensions will be slower, until these expenditures fall to 7 and 11 percent of GDP, respectively.

Despite the solid design and efficient work of the Fiscal Council, in most of the period since the adoption of the fiscal rules, the actual fiscal outcomes in Serbia were not within the limits established by the fiscal rules. Already since the end of 2012, the public debt has constantly been at a level higher than 45 percent of GDP, the fiscal deficit (except for part of the period from 2016 to 2019) has been higher than the target limit, wage expenditures have consistently been at a level above of the defined limit, while expenditures on pensions have been returned to the framework defined by fiscal rules since 2016.

At the end of 2022, Serbia made a fundamental reform to the fiscal rules. The backbone of the new generation of general fiscal rules consists of the following components: *i)* the target medium-term deficit has been reduced from

1 to 0.5 percent of GDP, and the permitted deviation from this target became exclusively a function of the level of public debt - the target fiscal balance was 0 percent of GDP, if public debt exceeds 60 percent of GDP, while if the public debt is less than 55 percent, or from 45 to 55 percent or below 45 percent of GDP, the target deficit would be 0 percent, 1.5 percent or 3 percent of GDP, respectively (see: [12]), *ii)* the limit for the public debt was raised from 45 to 60 percent of GDP. In the segment of special fiscal rules, the limit for wages of public sector employees and pensions is set at the level of 10 percent of GDP each. A new special fiscal rule also defines the method of pension indexation, so that, if the total mass of pensions is below the mentioned limit, pensions are indexed according to the growth rate of net wages in Serbia, while in the case that the mass of pensions amounts to 10-10.5 percent of GDP pensions are indexed according to the Swiss formula (average rate of wage growth and inflation), and in case the mass of pensions exceeds 10.5 percent of GDP, indexation is done only according to the inflation rate (see: [12]). Under new provisions, the government's response to violation of the fiscal rules, in terms of the implementation of the program to bring back the fiscal policy within the framework defined by the rules, was more precisely regulated. The application of the amended fiscal rules has been postponed until 2025 with the explanation that extraordinary crisis circumstances will be present in 2023 and 2024.

Considering the state of public finances, domestic and international experience and the need to create an institutional framework for sustainable and predictable fiscal policy, it is estimated that the new fiscal rules have several advantages and limitations. Reduction of the medium-term targeted fiscal deficit to 0.5 percent of GDP, inclusion of liabilities based on restitution in the limit regarding public debt, redefinition of special rules related to wages and pensions and a clear definition of pension indexation rules, as well as the elaboration of mechanisms for the government's response in case of breach of the rules, are considered advantages of the new fiscal rules. On the other hand, the raising of the public debt limit to the upper limit of the prohibitive zone, which reduces the fiscal buffers, the elimination of counter-cyclicality from the rules on the fiscal balance, and the absence of clear escape clause that would be applied in crisis are considered limitations of the new fiscal rules. Thus, with the new fiscal rule, it is possible for the government to conduct a loose fiscal policy in the period of economic boom, if the public debt is lower, and to be forced to a run a tight fiscal policy in the bust cycles if the public debt is close to or above the ceiling. In addition, since the crisis in 2023 and 2024 is not the only one to come, as different crises occur periodically, instead of postponing the application of new fiscal rules, it would be more expedient to develop escape clause that regulate the possibility of temporary deviation from fiscal rules in the crisis period.

The experience of a large number of countries shows that fiscal rules increase the chances to run a sustainable fiscal policy, if fiscal targets are set realistically and stable, if a solid escape clause and counter-cyclicality are incorporated into the fiscal framework and fiscal rules are set in clear and transparent manner. New fiscal rules in Serbia are clear, transparent and realistic, but lacking direct counter-cyclicality and escape clause. However, it is estimated that the new fiscal rules may have a positive impact on sustainability of fiscal policy in Serbia in the future, if the commitment of policy makers and attention of the general public to compliance of fiscal policy with the fiscal rules is substantially enhanced.

## Conclusion

Sustainability of fiscal policy is a substantial element of overall macroeconomic stability, which plays an important role in shaping the long-run economic growth perspectives [10]. Fiscal sustainability can be evaluated in many ways. In this paper, it is assessed by means of the three indicators: actual and structural fiscal balance, level of public debt and volume of government spending on interest payments. In the last three years, Serbia was running large fiscal deficits, both in absolute terms and in comparison to the other European countries, due to programs of financial support to businesses in pandemic, periodic non-targeted and non-means tested cash transfers to all citizens or to particular groups, as well as to sizeable outlays for subsidies to the state-owned companies in energy sector. Expansionary fiscal policy in Serbia is expected to continue in 2023 with the projected fiscal deficit of more than 3 percent of GDP. However, large part of the 2023 deficit is linked to energy sector risks, which is why structural fiscal deficit is expected to substantially narrow to around 1 percent of GDP. This implies that general fiscal framework, in terms of the main revenue and expenditure items in 2023 is designed in relatively sustainable way, while the main fiscal risks come from unreformed state-owned enterprises – in particular those in the energy sector.

In spite of the significant deficits in the last three years and significant rise of public debt in absolute terms (by EUR 9.4 billion), debt-to-GDP ratio in Serbia in that period rose only slightly (by 1.6 percent of GDP), due to currency structure of public debt, close to unchanged exchange rate of dinar to Euro and the high inflation. With the public debt of around 55 percent of GDP at the end of 2022, Serbia was close to European median and close to the other Western Balkans countries average, but still considerably above the average for the EU-CEE countries. In spite of being European median in terms of the level of public debt, Serbia performs high in respect of the volume of government spending on interest payments and the effective interest rate. Taking into account the fact that public debt in Serbia is close to the prohibitive zone, while the interest payment burden is substantial with strong crowding-out impact on more productive government spending or on potential tax cuts, keeping the public debt relatively low is the key element of sound fiscal policy. This is especially important under rising interest rates conditions, which will inflate interest spending in the future.

Legislating fiscal rules raises chances for sound fiscal policy, although the outcome is dependent on many institutional factors. Serbia introduced fiscal rules in 2010. However, for the most of the time, actual fiscal outcomes have not been within the limits set-out by the fiscal rules. At the end of 2022 Serbia implemented reform to the fiscal rules, by raising the public debt threshold and defining conditional fiscal deficit targets which are not directly linked to the economic cycles. While reduction of the long-term deficit target is the main strength of the new fiscal rule, lack of counter-cyclicality in the fiscal deficit rule and lack of clear escape clause are seen as their main limitation. Empirical literature suggests that in the developing countries, prohibitive threshold of public debt ranges from 45 percent to 60 percent of GDP [9], [13]. New fiscal rule in Serbia is at the upper bound of this range. Due to aforementioned reasons, it would be beneficial for Serbia to keep the public debt significantly below the limit introduced by new fiscal rules, thus creating the fiscal buffers for future crises and dampening the negative impact of monetary contraction on excessive rise in government spending on interest in the coming years.

Running fiscal policy within the sustainable fiscal outcomes is one way through which fiscal policy affects growth conditions. In addition to that, both theoretical and empirical literature suggest that structural characteristics of fiscal policy also plays an important role in creating conditions for economic growth [7]. In that respect, on the revenue side, shifting the tax burden from production factors (e.g. from labour taxes) to generators of negative externalities (e.g. to green/consumption taxes) in Serbia could be growth and welfare enhancing. At the same time, the tax policy reform should address the horizontal and vertical equality concerns, especially in terms of personal income and inheritance taxation, but to the extent that would not excessively harm economic efficiency. On the public spending side, continuing policy of large public investment in the long-run, with improvement of the system of selection, contracting and implementation of investment projects could make a considerable contribution to long-run growth perspectives. At the same time, other items of expenditure policy should be calibrated so as to fit into sustainable fiscal framework. To enhance the redistributive effects and equitability of expenditure policy, abandoning the policy of one-off or periodical non-targeted cash transfers and using that resources to increase the amount and coverage of well-targeted means-tested social welfare programs would be beneficial.

Fitting the fiscal policy into sustainable fiscal framework and continuous improvement in structural characteristics of fiscal policy may provide substantial contribution to Serbia's growth dynamics in the future. However, large fraction of economic growth drivers lay beyond the direct impact of fiscal policy. For the fiscal policy to exhibit maximum positive impact on economic growth, its refinement should go hand-in-hand with the reforms that should enhance other growth drivers – by means of strengthening the institutions and the rule of low, enhancing the efficiency of public administration and continuously improving the doing business environment.

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