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Fiscal Rules for the Western Balkans

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Abstract

Policy toward fiscal rules is an important issue in the countries of the Western Balkans (Albania, Bosnia and Herzegovina, Kosovo, Montenegro, North Macedonia, and Serbia). The countries with rules (all but North Macedonia) have, according to a rough estimate, complied with their debt and overall-deficit rules a little more than half the time. An online survey, conducted for this paper, suggests that public understanding of the rules is limited, which may reduce the political pressure for compliance. To get debt down to prudent levels, Albania and Montenegro will need a strong commitment to complying with their fiscal rules and will often have to do more than their deficit rules require. The following principles should guide future policy toward fiscal rules: more emphasis should be given to ensuring that fiscal rules are widely understood and enjoy the support of a broad range of stakeholders; policy toward the rules should be consistent with accession to the EU, but the rules should be simpler than the EU's and the debt limits lower; limits in rules should not be mistaken for targets; and public financial management should be improved to better support the implementation of rules.

SUMMARY

Fiscal rules have become an important subject of policy debate in the Western Balkans. The rise in public debt during the global financial crisis focused attention on strategies for restoring sound public finances, while plans to join the European Union (EU) mean that the countries will need to be in a position to adopt and comply with the EU's fiscal rules. This paper aims to help the countries make decisions about fiscal rules in the period before they join the EU.

Fiscal rules are long-term quantitative constraints on the government's spending, deficit, debt, or other fiscal aggregate. A few decades ago, only a handful of countries had fiscal rules; now more than 90 do, including, of course, the member states of the EU. All the countries of the Western Balkans apart from North Macedonia have established fiscal rules.

Fiscal rules are designed to limit the government's discretion over fiscal policy and thereby to limit the fiscal deficit and the growth of public debt. There is evidence that strong fiscal rules (e.g., those entrenched in the constitution and those for which compliance is monitored by an independent agency) foster fiscal discipline, at least in countries with a tradition of large deficits. But fiscal rules, especially self-imposed rules, cannot always be rigorously enforced: a government that can establish a fiscal rule may be able to abolish, circumvent, or ignore it. Thus the mere enactment of fiscal rules may not achieve much. Yet if fiscal rules enjoy widespread support, and compliance with them is politically important, they may guide fiscal policy even if they are difficult to enforce.

This paper's assessment of the fiscal rules in the Western Balkans has five main findings:

- A rough estimate suggests that the debt and overall-deficit rules have been complied with a little more than half the time. This is not out of line with the experience of other regions and is consistent with the difficulty of enforcing national fiscal rules.

- An online survey conducted for this paper reveals public awareness of fiscal rules, but also suggests that understanding of the rules may not be sufficient to give governments strong political incentives to comply with them, partly explaining imperfect compliance.

- A qualitative assessment of the rules against established criteria finds that the rules have both strengths and weaknesses. Some rules require fairly prudent levels of debt, but others are arguably too permissive for countries that borrow mainly in currencies that they do not control. Some rules are admirably flexible or impressively comprehensive, but these benefits come at the cost of considerable complexity, which may explain why they are not always widely understood.

- Quantitative analyses show that some countries in the region with high debt will have to do more than merely comply with their overall-deficit rules to get their debt down to prudent levels by the time of possible EU membership. That does not make the achievement of prudent debt levels impossible: the countries have sometimes run deficits that are smaller than those permitted by the overall-deficit rules, and the overall-deficit

rules are not the only rules that constrain fiscal policy. But macroeconomic modeling shows that Albania and Montenegro in particular will need strong commitment to compliance with the rules—probably stronger commitment than has been demonstrated in the recent past. Moreover, all the countries in the region need to keep in mind that how debt evolves will depend on unpredictable economic shocks. Taking account of possible shocks, the modeling shows that, even if government commitment is strong enough to reduce debt in a timely manner under normal economic conditions, the range of possible outcomes for future debt is wide. To be confident of reaching a debt target, governments will thus have to aim for debt that is lower than the target.

- A review of assessments of public financial management in the region shows that many of the basic elements needed to support fiscal rules are in place. But accounting and statistics are not always robust enough to reveal when success in complying with fiscal rules has occurred at the expense of, say, accumulating arrears or shifting spending responsibilities to state-owned enterprises. Moreover, fiscal forecasts have often been optimistic, making future compliance with the rules seem easier than it really is. Recent attempts to solve this problem have included the creation of independent fiscal councils and the use of forecasts produced by the IMF or European Commission.

The paper suggests five principles to guide economic policy toward fiscal rules in the region:

- First, more emphasis should be given to ensuring that fiscal rules are widely understood and enjoy the support of a broad range of stakeholders.

- Second, policy toward fiscal rules should be consistent with accession to the EU, though the rules should be simpler than the EU's, the debt limits should be lower, and the changes that are prioritized should be those that will be beneficial even if accession to the EU is delayed (a no-regrets approach).

- Third, limits should not be mistaken for targets. For example, if the deficit limit is 3 percent of GDP, it should not be assumed that a deficit of 3 percent is usually reasonable. During economic booms, a surplus may be appropriate.

- Fourth, the aspects of public financial management that support the implementation of fiscal rules, including independent statistical agencies and monitoring institutions, should continue to be improved. This will be beneficial no matter which rules are in place.

- Fifth, and somewhat more technically, the rules and targets in place should both establish a long-term objective—normally for public debt—and specify the steps that should be taken in the short term—normally in public spending or the deficit—to ensure that progress is made in achieving the long-term objective.

I. INTRODUCTION

What rules should govern fiscal policy in the Western Balkans? Four of the countries in the region—Albania, Montenegro, North Macedonia, and Serbia—are official candidates to join the European Union (EU). The other two—Bosnia and Herzegovina and Kosovo—are "potential candidates."[1] When the countries do join the EU, they will be required to adopt and comply with the EU's fiscal rules. In the meantime, they need to consider their own approaches, taking account of the need to conduct sound fiscal policies for purely domestic reasons.

The countries are different in various respects, and each must make its own decisions about fiscal rules. Kosovo has a relatively small government and a relatively low level of public debt. Montenegro has a relatively large public sector and, like Albania and Serbia, a relatively high level of public debt. Bosnia and Herzegovina is distinctive in the extent of its fiscal decentralization. There are also relevant differences in monetary and exchange-rate regimes. Kosovo and Montenegro both use the euro, while Bosnia and Herzegovina has a currency board and North Macedonia has a *de facto* euro peg. In these countries, fiscal policy is the only major tool of economic stabilization and thus needs to be disciplined during economic booms but flexible enough to allow deficit spending during recessions. Albania and Serbia have flexible exchange rates, allowing some of the burden of stabilization to be borne by monetary policy and the exchange rate.

Yet the countries have enough in common to warrant considering their choices together. All are upper-middle-income countries. Public finances in all the countries deteriorated during the global financial crisis. (World Bank 2017). Bringing debt down to safer levels will require slowing the growth of public wages and pensions, which are high in the region. All the countries are working to establish their credibility with investors; none yet has an investment-grade rating. Although there are some differences, the countries also have relatively similar systems of budgeting, accounting, and medium-term fiscal planning. Inflation is low throughout the region. All the countries' choices about fiscal rules will be shaped by the prospect of joining the EU. And they can all learn from each other's experiences, since they have already experimented with a wide variety of fiscal rules. (Table 1 provides some background information on the countries.)

[1] See https://europa.eu/european-union/about-eu/countries_en (accessed September 30, 2018).

Table 1. Countries of the Western Balkans: Some Basic Indicators

	GDP per capita in $1000 at purchasing-power parity, 2018	Public spending, % of GDP, 2018	Government and government-guaranteed debt, % of GDP, 2018	Fiscal balance, % of GDP, average 2015–18	Monetary-and-exchange-rate regime	EU-accession status
Albania	13.3	29.0	68.6	-2.6	Inflation targeting	Candidate
Bosnia and Herzegovina	13.5	44.3	36.7	1.0	Euro currency board	Potential candidate
Kosovo	11.3	29.6	16.8	-1.8	Euro	Potential candidate
North Macedonia	15.5	31.5	48.5	-2.5	Inflation targeting	Candidate
Montenegro	18.9	46.2	75.7	-4.9	Euro	Candidate
Serbia	16.0	41.0	54.3	-0.8	Inflation targeting	Candidate

Sources: World Bank Staff; European Commission (status of EU accession).

This paper aims to help the Western Balkans countries refine their approach to fiscal rules. Section II provides background on fiscal rules—what they are, how common they are around the world, and how they work (when they do). Section III describes the fiscal rules that are in place in the Western Balkans. Section IV assesses the rules, considering whether they have been followed; whether there is enough public awareness of their content; whether they appear to be well-designed, from both a qualitative and a quantitative perspective; and whether they are well supported by public financial management. Section V concludes by suggesting five principles to govern policy toward fiscal rules in the Western Balkans in the period before the countries join the EU.

II. Overview of Fiscal Rules

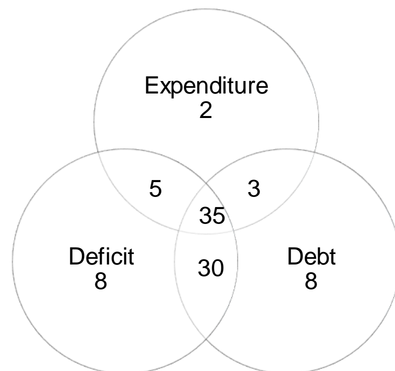
Fiscal rules are long-term numerical constraints on fiscal aggregates (Kopits and Symanksy 1998). The most common rules limit the government's debt or deficit or the growth of its spending. Fiscal rules can be distinguished from other kinds of fiscal norms, including:

- Shorter-term fiscal constraints, such as the annual spending limits in the budgets of all the countries in the region, and most medium-term fiscal plans
- Nonbinding fiscal targets, like North Macedonia's plan to keep debt below 60 percent of GDP

- Nonnumerical fiscal principles, like the requirement in Montenegro's Law on Budgets and Fiscal Responsibility that borrowing policy aim at ensuring fiscal sustainability
- Procedural fiscal rules, like the requirement in Kosovo's Law on Public Debt that external borrowing be approved by two-thirds of the parliament.

Once rare, fiscal rules are now widespread. The IMF's database of fiscal rules identifies only 6 countries that had an expenditure, revenue, deficit, or debt rule in 1985.[2] By 2015, however, 92 countries had at least one of those rules; 78 had a deficit rule, 76 a debt rule, 45 an expenditure rule, and 14 a revenue rule. The distribution of the three most common rules is given in the Venn diagram in Figure 1. It shows, among other things, that 35 countries had debt, deficit, and expenditure rules in 2015 and 30 countries had both debt and deficit rules but no expenditure rule.

Figure 1. Number of Countries with Debt, Deficit, and Expenditure Rules in 2015



Source: World Bank Staff calculations using data from the IMF's Fiscal Rules Database (accessed September 29, 2018).

Though most fiscal rules are easily summarized, their content depends on many details. To say, for example, that the government cannot run a fiscal deficit is to say very little until "deficit" and "government" have been clearly defined. For example, is the deficit measured on a cash basis or an accrual basis? Does the rule apply to the central government, general government (local government and central government), or the whole public sector (including public enterprises)? Answering these questions in sufficient detail to allow rigorous tests of compliance is not easy (see, e.g., Eurostat 2016). The EU's two oldest fiscal rules, to take a concrete example, require the government's deficit to be less than 3 percent of GDP and its debt to be less than 60 percent of GDP. (There are now other rules, and the system is very complex; see Kopits 2018). But to know how the EU's rules compare to similar-sounding rules in region, it is necessary to understand that:

- The EU rules apply to general government, defined as the public sector apart from the central bank and public enterprises that operate on a commercial basis.

[2] See https://www.imf.org/external/datamapper/FiscalRules/map/map.htm (accessed September 29, 2018). See also Budina and others (2013) and Lledó and others (2017).

- The deficit is measured in a way that treats investment in physical assets as expenditure in the year of the investment, but otherwise follows the accrual basis of accounting.
- Debt is defined to include loans, bonds, and financial leases, among other liabilities, but not, for example, pensions and accounts payable; and it is measured at face value, not, for example, at market value or amortized cost.

Fiscal rules are intended to correct a bias toward excessive deficits. History shows that the unfettered exercise of fiscal discretion often leads to large deficits and eventually unmanageable debts, as governments try to win votes by spending more and taxing less. Fiscal rules hold out the promise of solving this problem by stopping politicians from pursuing fiscal policies that the country will later regret. Fiscal rules may thus help prevent debt crises and help keep inflation low and stable, thereby encouraging productive investment and economic growth.

But fiscal rules, especially self-imposed rules, are hard to enforce. A strong central government in a unitary state can impose fiscal rules on local governments and enforce those rules. To a lesser extent, a supranational entity like the EU may have some ability to impose fiscal rules on its member states. Even in these cases enforcement can be politically difficult, but enforcement is harder still for self-imposed national fiscal rules. A government that chooses to adopt a rule may also be able to revoke it, circumvent it, or ignore it. Entrenching fiscal rules in the constitution or in a law whose amendment requires a supermajority and having compliance with the rules monitored by an independent body can, however, help.

When national fiscal rules work, it is partly by changing the politics of fiscal policy. When they work, it is partly because breaking them erodes government's credibility (e.g., Wyplosz 2012). For example, because a respected independent fiscal institution makes clear whether the rules have been followed or not, and news media consider the issue worth highlighting. Rules that succeed in changing the politics of fiscal policy can also persuade investors that fiscal policy will become more prudent and can thus reduce the government's borrowing costs (Debrun and Kumar 2007).

Fiscal rules cannot work wonders. If self-imposed rules become too restrictive, the political cost of abandoning them may be less than the political cost of complying with them. And even if the government follows the rules, the results may not always be those that were hoped for. Good rules are simple, but simple rules sometimes preclude the best choices: simple rules may, for example, stop a government from running a sufficiently large deficit to stabilize the economy during a recession. Moreover, though fiscal rules set limits, not targets, the limits may come to act like targets, or magnets. Thus, a rule that says that the deficit may never exceed 3 percent of GDP may be taken to mean that a deficit of 3 percent of GDP is always reasonable, encouraging excessive deficits in good times. Fiscal rules also tend to foster creative accounting, as governments seek to comply with the rules without making unpopular choices. More generally, fiscal rules strengthen the unintended effects of accounting choices. Rules that limit the cash deficit, for example, can encourage the build-up of spending or tax-refund arrears and discourage spending on revenue-generating public investments (Easterly and Servén 2003, Blanchard and Giavazzi 2008, Servén

2008). At worst, governments may adopt fiscal rules with little intention of following them, perhaps to please international advisers and lenders (see Andrews 2003, Schick 2013).

To work, fiscal rules need the support of public financial management. It must be possible to measure whether the government has complied with the rules, so reliable accounts and statistics are needed. The measurements should also be credible to outsiders, so it is helpful if accounts and statistics follow international standards and are independently audited or prepared. It is easier for a government to follow fiscal rules if it has unbiased and reasonably accurate forecasts and understands the risks surrounding those forecasts. Having an independent fiscal institution make or check the forecasts can help ensure that the government's predictions of compliance with rules are believable. Since most tax and spending programs cannot efficiently be changed overnight, effective systems of medium-term planning are valuable. And good budgeting and expenditure control can help the government to stick to the spending plans it has made.

The main alternative to fiscal rules is to rely on quantitative fiscal targets and good public financial management. Well-designed budgeting, forecasting, accounting, and fiscal statistics can reveal the long-term fiscal costs of short-sighted policies, and a focus on prudent fiscal policy can be encouraged by a procedural rule requiring the government to announce its fiscal targets and to report publicly on whether it has achieved them. This approach is not legally constraining, but by raising the political costs of running of an imprudent fiscal policy, it may have an effect similar to that of fiscal rules. Indeed, though fiscal targets are different from fiscal rules that are externally imposed and rigorously enforced, they may be similar to self-imposed fiscal rules.

Reliable empirical evidence on the effects of fiscal rules is hard to obtain. Countries with fiscal rules tend to have lower debts and deficits than other countries (Eyraud and others 2018), which suggests that fiscal rules work. But disentangling cause and effect is difficult. The countries that adopt fiscal rules may be those in which there is the greatest popular support for fiscal discipline, so a positive association does not imply that it is the rules that are causing the discipline: the rules and the discipline may both be expressions of the underlying social preferences. Conversely, evidence that fiscal rules are often breached does not imply that the rules are not helping: it is possible that fiscal performance would have been even worse in the absence of the rules.

Recent evidence suggests that strong fiscal rules reduce deficits, at least in some countries. Summarizing recent empirical work, Eyraud and others (2018) conclude that "strong" fiscal rules reduce deficits—where the strength of rules increases with factors such as independent monitoring and entrenchment of rules in constitutions or supranational treaties. The work also finds that fiscal rules reduce deficits in countries with a tendency to especially high deficits. At the same time, however, the work finds that rules appear to *increase* deficits in countries where fiscal policy would otherwise be especially prudent, perhaps because of the abovementioned tendency of rules to act like magnets.

III. Fiscal Rules in the Western Balkans

Five of the six countries of the Western Balkans already have fiscal rules in place. The remaining one, North Macedonia, is considering their adoption as part of a reform of the organic budget law. Most of the existing rules were established after the increases in debt that occurred during the global financial crisis. Some countries' rules have been inspired by the EU's main debt and deficit rules, but the choices have also reflected local circumstances and concerns, and a wide variety of approaches is in evidence (Table 2). Most countries have a rule limiting debt, though the size and the nature of the limit varies. Also common are rules limiting the overall deficit (i.e., the deficit including interest and investment spending) or the current deficit (i.e., the deficit excluding investment spending). One country has a rule limiting the primary deficit (i.e., the deficit excluding interest). As in the EU, the main debt and deficit rules typically apply in principle to general government. Also as in the EU, debt appears in all countries to be measured at face value and to include loans and bonds but not liabilities such as accounts payable.[3] By contrast, the deficit rules generally apply to the cash deficit, not an accrual measure of the deficit as in the EU, while the definition of general government (which determines the institutional coverage of the rules) is in practice less rigorous than in the EU. Many of the rules come with an escape clause that allows for their suspension in extraordinary circumstances.

Table 2. Summary of Debt and Deficit Limits
Percent of GDP

		Deficit		
	Debt	**Overall**	**Current**	**Primary**
Albania	Decline to 45	2 if $g_t > 5$	0	
Bosnia and Herzegovina				
Federation of Bosnia and Herzegovina	60		0	
Republika Srpska	55	3		
Kosovo	40	2		
North Macedonia				
Montenegro	60	3	0	0
Serbia	45	$1.9 + 0.7d_{t-1} - 0.4g_t$		

Sources: See text.
Note: g_t is the rate of real economic growth and d_{t-1} is last year's overall deficit. Kosovo's rule applies to the overall deficit, but donor-financed investment is excepted, so it is a current-deficit rule to the extent that donors finance investment. The formula for Serbia's rule is explained below.

In Albania, the main fiscal rule is designed to reduce debt to 45 percent of GDP. In 2008, the Law on the Management of Budgets, whose amendment requires a three-fifths majority in parliament, limited public debt to 60 percent of GDP (article 58 of law 9936 of 2008). This rule was, however, repealed in 2012 (IMF 2017). In 2016, the law was amended again, to require each

[3] The measurement of debt differs from the ESA2010 or GFS2014 in most of the countries, which makes cross-country comparisons difficult.

budget, supplementary budget, and medium-term plan to provide for debt to decline each year until it falls below 45 percent of GDP, save in exceptional circumstances (articles 4/1 and 4/4 of law 57 of 2016). Debt is defined as the direct and guaranteed debt of general government (article 4/2). The government has also set itself the interim target of reducing debt to 60 percent of GDP by 2021 (IMF 2017). To help ensure that compliance with the rule is not undermined by optimism, the forecasts of GDP used by the government cannot exceed those published by the IMF in its *World Economic Outlook*—an example of the use of external checks to foster compliance with rules.

Albania's debt rule is supplemented by several others. If the forecast annual rate of real economic growth is more than 5 percent, the cash deficit of general government must be less than 2 percent of GDP (article 4/1). There is also a golden rule, namely one that requires current spending to be paid for by current revenue while allowing investment spending to be financed by borrowing (article 4/1(4)). The government must also keep 0.7 percent of budgeted expenditure in reserve to deal with unexpected events (article 4/1). And there are rules that limit the speed at which deficits can build up during an election year: for example, the actual deficit for the first quarter of the year cannot exceed 30 percent of the planned deficit for the whole year (article 4/3).

In Bosnia and Herzegovina, each of the two entities has its own fiscal rules. No rules apply to central government, but its contribution to the country's finances is modest.

- In the Federation of Bosnia and Herzegovina, the 2013 Law on Budgets applies a golden rule to the planned budgets of all levels of government (investment is defined in article 43 as the net acquisition of nonfinancial assets). If a government nevertheless runs a current deficit, it must plan for compensating current surpluses over the next three years. In addition, the 2016 Law on Debt, Borrowing, and Guarantees limits direct government debt to 60 percent of GDP and government-guaranteed debt to 25 percent of GDP (articles 76(1) and 77). Finally, total debt service is also limited to 18 percent of revenue.[4]
- In Republika Srpska, the 2015 Law on Fiscal Responsibility limits the overall deficit and debt of all levels of government to 3 percent and 55 percent of GDP, respectively (article 6). If the deficit and debt reach 2.5 percent and 50 percent of GDP, respectively, the budget for the next year should be in surplus. The 2012 Law on Borrowing, Debt, and Guarantees establishes various other limits on debt as a percent of the prior year's revenue: roughly speaking, short-term debt cannot exceed 8 percent, and the government cannot borrow long term if that would cause total debt service to exceed 18 percent. Guarantees cannot exceed 15 percent of GDP. There is also a fiscal council that assesses, among other things, the

[4] See Bosna i Hercegovina Fiskalno Vijeće, Globalni okvir fiskalnog bilansa i politika u Bosni i Hercegovini, 2017–2019 (Fiscal Council of Bosnia and Herzegovina, Global Fiscal Balance and Policy Framework of Bosnia and Herzegovina, 2017–2019), p. 42, available at http://mft.gov.ba/bos/images/stories/budzet/gfo/GO%20BiH%202017-2019_korigovano_230516%20bos%20tb.pdf (accessed December 12, 2018).

assumptions underlying macroeconomic forecasts and whether the government has complied with the fiscal rules.[5]

Kosovo has a relatively tight debt limit and a deficit limit with an exception for investment. Kosovo's first fiscal rule, introduced in 2006, limited the real growth rate of spending to 0.5 percent a year, but this rule was soon deemed too restrictive, and it was repealed in 2008. More enduring has been a rule in the Law on Public Debt 2009 that limits debt to 40 percent of GDP (article 5). Debt is defined as the direct debt of general government plus guarantees issued by general government. In 2013, the debt rule was supplemented by a rule limiting the overall cash deficit of general government to 2 percent of forecast GDP (article 22A of the 2013 law amending the Law on Public Financial Management and Accountability). In 2016, this deficit rule was relaxed by excluding investment spending financed by foreign donors and privatization proceeds. This investment exemption, which expires at the end of 2025, applies only while the debt of general government is below 30 percent of GDP (article 7 of the law of 2015 amending the Law on Public Financial Management and Accountability). The growth rate of the public wage bill cannot exceed the growth rate of GDP (article 8), a rule implemented for the first time in 2018. And separately there is a cap on pensions to war veterans of 0.7 percent of GDP (article 16A of the Law on Kosovo Liberation Army War Veterans), though this has not yet been implemented.

North Macedonia is considering the adoption of fiscal rules. Recent plans for public financial management include the "formulation, adoption, and implementation of fiscal rules."[6] Other planned measures include greater fiscal transparency, the creation of an independent fiscal council, and improvements in the forecasting of GDP and public finances. In the absence of fiscal rules, the country's fiscal policy is guided by a medium-term fiscal strategy. The strategy for 2019–21 for the first time introduced some targets: it aimed to keep debt below 60 percent of GDP and guarantees below 13 percent of GDP, and it introduced indicative spending limits.[7]

Montenegro has a broad array of fiscal rules. The 2014 Law on Budgets and Fiscal Responsibility (amended in 2018), passed with a simple majority, requires the following:

- The debt of general government must be less than 60 percent of GDP (article 20).
- Guarantees granted by the state must be less than of 15 percent of GDP (article 53).
- The primary and current balances of general government must both be positive (article 19).
- The overall cash deficit of general government cannot exceed 3 percent of GDP (article 20), though spending on natural disasters and other shocks and EU projects is excepted.

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[5] See http://fiskalnisavjetrs.net/?lang=bs (accessed February 26, 2019).
[6] See Ministry of Finance, Public Financial Management Reform Program, pp. 10–11, at https://www.finance.gov.mk/en (accessed October 1, 2018).
[7] See *2019–2021 Fiscal Strategy of the Republic of Macedonia*, May 2018 (p. 3), available at https://www.finance.gov.mk/files/Fiskalna%20Strategija%20na%20RM%202019_2021_FINAL_EN.pdf (accessed October 4, 2018).

- The deficit of each local government cannot be more than 10 percent of its revenue, unless the ministry of finance approves additional capital spending (article 27).
- The planned growth rate of the central government's spending (excluding interest, the spending of donor funds, the cost of natural disasters, etc.) is limited to the forecast growth rate of GDP: nominal *current* spending can grow no faster than *real* GDP, while nominal *capital* spending and the budget reserve may grow at the rate of *nominal* GDP (article 22).

The law also requires the government to submit to parliament plans for reducing the deficit and debt if the 3 or 60 percent rules are breached, and it established a fiscal council in the State Audit Office. There are additional rules for local governments that limit their deficits to a maximum of 10 percent of their revenue, with the exception of investment projects approved by the Ministry of Finance.

Serbia has a debt rule and a formula-based deficit rule. Since 2010, the Budget System Law has limited the direct and guaranteed debt of general government to 45 percent of GDP (article 27e). (Liabilities for restitutions related to the nationalization of assets after World War II are excluded.) The deficit rule is more complex. The idea is that the deficit of general government should generally be no more than 1 percent of GDP, but the maximum deficit in any given year depends on the previous year's deficit and this year's real economic growth. Given the current choice of the formula's parameters,[8] the maximum deficit in percent of GDP is

$$1.9 + 0.7 \times \text{Previous deficit} - 0.4 \times \text{Growth rate}$$

The formula implies that if last year's deficit was 1 percent of GDP and GDP growth this year is 4 percent (its long-run average according to the law), this year's maximum deficit is 1 percent of GDP. But the rule permits bigger deficits when growth is lower: if growth falls to 3 percent, for example, this year's maximum deficit rises to 1.4 percent. The rule also allows for gradual adjustment: if growth is 4 percent, but last year's deficit was 3 percent, this year's maximum deficit would be 2.4 percent. An escape clause allows the suspension of the rules after natural disasters and other shocks (article 27z).

These rules are supplemented by others and monitored by a fiscal council. As well as the limits on the debt and deficit, there are rules limiting the growth of wages and pensions (article 27e), and each local government is subject to both a golden rule and a rule limiting its overall deficit to 10 percent of its revenue (article 27ž). The law also established an independent fiscal council that monitors compliance with the rules.

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[8] The rule is usually written in a more-general form, as follows. Let d denote the deficit as a share of GDP, let g denote the real growth rate, and let subscript t index years. Then the maximum deficit in year t according to the law is $d_{t-1} - a(d_{t-1} - d) - b(g_t - g)$. For the moment, however, the parameters have been set at $a = 0.3$, $b = 0.4$, $d = .01$, and $g = 0.04$, so the maximum deficit is $d_{t-1} - 0.3(d_{t-1} - 0.01) - 0.4(g_t - .04)$. Rearranging this formula gives the one in the text. If the actual deficit equals the maximum permitted deficit, we have $d_t = 0.019 + 0.7d_{t-1} - 0.4g_t$, and the equilibrium deficit, d^*, is given by $d^* = 0.019 + 0.7d^* - 0.4(0.04)$ or $d^* = (0.019 - 0.4g_t)/0.03$. If the actual growth rate is 0.04, then $d^* = 0.01$.

IV. An Assessment of the Rules

How satisfactory are the approaches currently in place? To answer, we consider the following questions in turn:

- Have governments complied with the rules?
- Are the rules sufficiently widely understood to be politically effective?
- What are the qualitative strengths and weaknesses of the rules?
- To what extent will the rules help get debt down to prudent levels?
- How well do the rules appear to be supported by public financial management?

Have governments complied with the rules?

Consider first compliance. As noted above, it is possible for rules to influence fiscal policy even if compliance with them is low (and it is also possible for them to have little influence even if compliance is high). The crucial question is the counterfactual one: what would have happened in the absence of the rules? The available data are not sufficient to answer this question. Nonetheless, it is useful to have an idea of the extent of compliance, because a high rate of noncompliance is suggestive of problems. Given the complexity of fiscal rules—including the existence of escape clauses and subtle differences in accounting—it is difficult to provide definitive evidence even about this question.

A quick review suggests that fiscal rules in the Western Balkans have been followed a little more often than not. The evidence is set out in Table 3, in which green shading shows compliance with the rules, red shading shows noncompliance, and absence of shading implies that no rule was in force. The table is rough in several ways. Only the debt and overall-deficit rules are considered; no account is taken of rules on current and primary deficits, expenditure, and guarantees. The data on actual debts and deficits also come from the World Bank's database, and may differ in some respects from the data used domestically to define the debts and deficits that are subject to the rules. Third, no account is taken of escape clauses and other subtleties in the rules. Subject to the provisos mentioned above, the table suggests the following:

- Albania has followed its debt rules in most years, though the original debt rule was repealed as soon as it was breached
- Kosovo has followed its debt rule every year and its deficit rule most of the time
- Montenegro has generally not complied with its debt and overall-deficit rules
- Serbia has usually not complied with its debt rule, but, according to the approximate data used here, has often complied with its complex deficit rule.

Bosnia and Herzegovina's rules are not considered in the table because they are subnational rules.

For the region as a whole, the evidence suggests that governments have complied with the debt and overall-deficit rules a little more than half the time, which is similar to the experience of other regions (Eyraud and others 2018).

Table 3. Overall Deficit, Debts, and Indicative Compliance with Rules
Percent of GDP

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Albania											
Deficit	3.5	5.6	7.1	3.1	3.5	3.4	5.1	6.0	4.9	1.8	2.0
Debt	53.5	55.1	59.7	57.7	59.4	62.1	70.4	72.0	72.7	72.3	71.8
Bosnia and Herzegovina											
Deficit	-1.3	-8.6	5.3	3.1	1.6	2.6	2.2	2.0	-0.7	-1.2	-2.6
Debt	19.6	20.2	26.7	31.7	34.3	38.0	39.1	43.1	43.2	43.3	38.0
Kosovo											
Deficit	-7.3	0.2	-1.3	1.1	1.1	2.2	3.1	2.6	2.0	1.4	1.2
Debt	0.0	0.0	6.1	5.9	5.3	8.1	9.0	10.6	12.8	14.4	16.3
North Macedonia											
Deficit	-0.6	1.1	2.7	2.4	2.6	3.9	4.0	4.2	3.4	2.7	2.8
Debt	25.8	23.0	26.2	27.2	32.0	38.3	40.3	45.8	46.6	48.8	47.8
Montenegro											
Deficit	-6.2	0.3	5.3	3.6	5.1	5.3	5.2	3.1	7.3	2.8	5.6
Debt	31.4	32.3	41.6	50.7	57.2	65.4	66.0	67.1	73.7	71.4	70.0
Serbia											
Deficit	1.7	2.4	4.1	4.4	4.6	6.8	5.3	6.2	3.4	1.2	-1.1
Debt	28.4	25.2	31.0	39.6	43.0	54.0	56.5	65.4	70.6	68.6	60.1

Sources: World Bank Staff estimates of the overall deficit and public and publicly guaranteed debt from the February 2019 database compiled for the Regular Economic Report for the Western Balkans.

Note: The assessments for Albania's and Serbia's deficit rules rely also on estimates of real rates of economic growth from the same database. Albania's growth rate in 2017 was below the threshold that triggers the maximum-deficit rule, so that cell is not shaded.

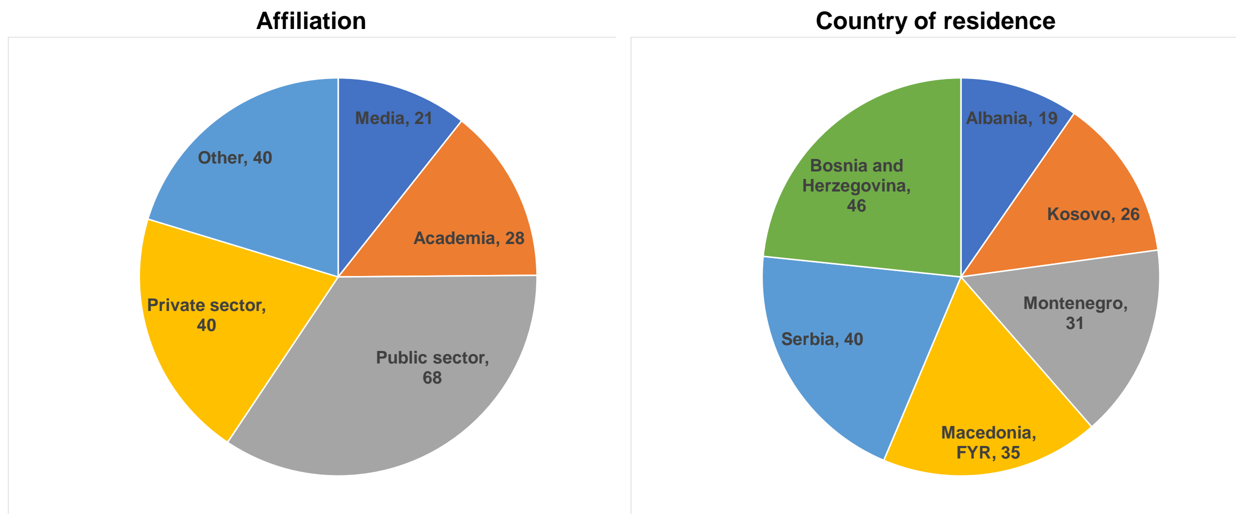
How well known are the rules?

One factor that is likely to affect compliance is whether the rules are widely understood. As noted earlier, national fiscal rules are more likely to work when noncompliance is politically embarrassing, and this in turn is more likely if the rules are well understood, at least among a group of politicians, journalists, academics, think-tank analysts, businesspeople, and others interested in public finances.

To shed some light on the extent of public awareness of fiscal rules, the World Bank conducted an online survey on the subject in December 2018 (see Appendix). In all, there were 197 responses to the survey, which asked 19 questions. The respondents were from all the countries

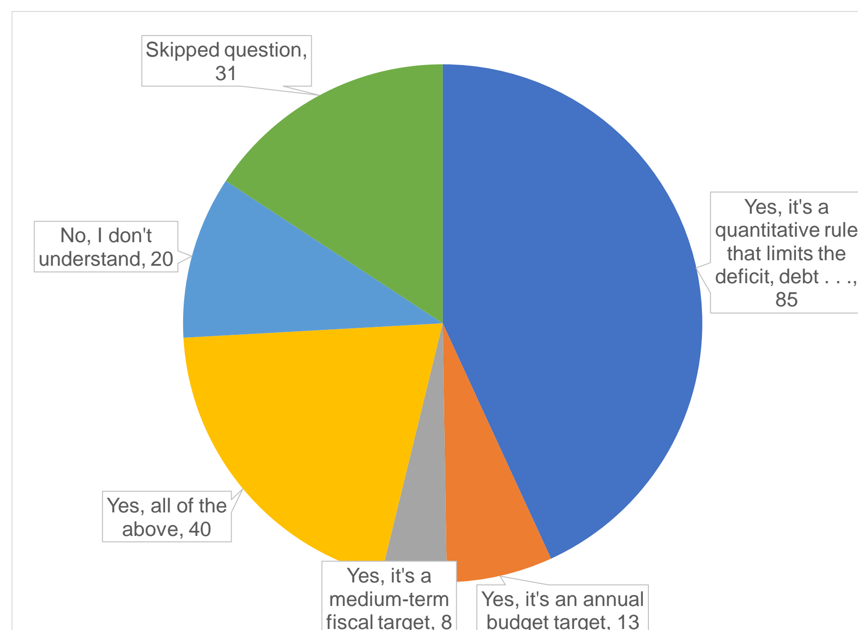
of the region, though representation varied from country to country, and were from many backgrounds, including the media, business, academia, the public sector, and elsewhere (Figure 2). The survey was not intended to be representative of the populations of the countries: those who responded were probably more likely than the average person to be interested in government policy and public finances. Consistent with this, about three-quarters of respondents expressed concern about the fiscal situation in their country, and most people who answered the question “Have you ever read the report of the fiscal rules monitoring body in your country?” (90 respondents skipped the question) said “yes.” Of those who said they had not read the report, only 21 percent said the reason was a lack of interest.

Figure 2. Respondents to Survey on Fiscal Rules in the Western Balkans



Most respondents said they understood the fiscal rules in place in their country, though the answers also suggest some misunderstandings. Many respondents knew what a fiscal rule was and were able to identify some or all of the fiscal rules in place in their countries. In Albania, the debt-reduction rule was sufficiently well-known to be identified by two-thirds of the respondents, and in Kosovo a small majority were aware of both the debt rule and the deficit rule. But several respondents did not distinguish fiscal rules from annual budget limits or medium-term fiscal targets (Figure 3). Consistent with this, most North Macedonian respondents thought their country did have a fiscal rule, whereas by the definition used in this paper it does not. And in many countries, the fiscal rules did not seem to be very well understood even among the presumably relatively well-informed respondents. In Serbia, most respondents (incorrectly) thought the country had a debt-reduction rule along the lines of Albania’s—though a large majority were aware of the fiscal council’s role in monitoring compliance with fiscal rules, and most respondents said that they had read the survey. Overall, the results are consistent with the view that public awareness of fiscal rules is only moderate, and that in some countries the rules are too complicated to be understood well.

Figure 3: Do You Understand the Definition of the Fiscal Rule in Your Country?
Number of respondents



Source: Online survey conducted by the World Bank in late 2018. Some of the possible answers are abbreviated in the Figure.

Several other noteworthy results emerged from the survey:

- Respondents who thought fiscal rules were not being followed were most likely to blame the public-sector wage bill and other current spending. Other cited factors included tax exemptions and low tax collection and the circumvention of the rules, by statistical tricks or cuts in maintenance and public investment.
- But most respondents (around two-thirds) thought fiscal rules contributed positively to budgeting, accounting, and fiscal performance in their countries. Of those who did not believe this, some pointed to a lack of transparency (32 percent), and some said governments did not respect the rules (20 percent).
- Most of the respondents said that the rules were determined to satisfy the requirements of international creditors. They pointed to a lack of political will, a lack of knowledge, and corruption, poor management, lack of supervision over implementation as issues.
- Most respondents (85 percent) believed that the reports on fiscal rules produced by fiscal watchdogs were credible. Some 42 percent said that the establishment of a fiscal council or an expert independent body would encourage prudent fiscal policies. But many also implied that stronger transparency and oversight of the enforcement of fiscal rules—especially in election years—was needed. Some thought that compulsory sanctions for noncompliance with fiscal rules should be put in place.

Even if the rules were widely understood and governments always complied with them, the question would still arise: are they the right rules? This question is addressed in two ways: first with a qualitative assessment of the rules' strengths and weaknesses, and second with some quantitative analysis of the likely effects of the rules.

What are the qualitative strengths and weaknesses of the rules?

Considered qualitatively, the rules have both strengths and weaknesses. This is to be expected since there are trade-offs between objectives like simplicity and flexibility, and no set of rules can perform well according to all criteria. A few points stand out:

- The debt limits of Kosovo and Serbia are fairly prudent. Those in Bosnia and Herzegovina and of Montenegro appear rather high. Judgements about appropriate debt are, of course, somewhat subjective,[9] and some advanced economies tolerate debt well above 60 percent of GDP. But it is commonly thought that developing and emerging countries should seek to keep debt well below 60 percent of GDP, especially if they borrow mainly in currencies they do not control.
- Albania's debt target is also fairly prudent, but its debt rule does not ensure any particular speed of progress toward the target. Making good progress will thus require doing more than simply complying with the rule in most years. By contrast, the rule may be too demanding during recessions that are not severe enough to trigger the escape clause.
- Serbia's formula-based deficit rule is attractive in allowing gradual adjustment and countercyclical fiscal policy, but its complexity makes it hard to explain to the public and to politicians. This is a problem to the extent that its effectiveness depends on noncompliance having a political cost. In Montenegro, most of the rules are simple enough taken one by one, but the sheer number of rules may reduce their political effectiveness. The frequent changes in Kosovo's rules raise similar concerns.
- More generally, it is not clear how well-embedded the rules are in the politics of the countries. Albania's are the only ones enacted by a legislative supermajority. Indeed, there is a widespread perception that the rules in the region have been introduced to satisfy external parties such as the EU or the IMF and they do not enjoy much intrinsic domestic support.

[9] They depend first on technical estimates than cannot be made with precision (e.g., what is the probability in the country of a fiscal crisis in the next five years if debt is 60 percent of GDP?) and, second, on the country's tolerance for risk (e.g., is a 5 percent probability of a crisis acceptable?), which is not something about which policymakers or the public are likely to have a clear view.

This assessment can be made systematic by considering each country's rules against established criteria. Kopits and Symansky (1998) set out and explains eight such criteria:

- Definition: are the rules sufficiently well specified?
- Transparency: can compliance with the rules be monitored in a timely manner, according to high-quality accounting standards?
- Adequacy: will compliance with the rules lead to the achievement of the rules' declared objectives?
- Consistency: are the rules consistent with each other and with the monetary regime?
- Simplicity: is it easy for politicians and others to understand the rules?
- Flexibility: do the rules allow the government to run deficits during recessions and after other major shocks?
- Enforceability: are the rules, especially those applied to subnational governments, enforceable?
- Efficiency: does compliance with the rules allow for efficient allocation of resources?

Table 4 summarizes an assessment of the rules against these criteria.

Table 4. Rules Assessed against the Kopits-Symansky Criteria

	Albania	Bosnia and Herzegovina	Kosovo	Montenegro	Serbia
Well defined	+	+	++	++	+
Transparent	++	+	++		++
Adequate	+	++	++		+
Consistent	+	+	+		+
Simple	++	+++	+	++	+
Flexible	++	++	++	++	++
Enforceable	++	+	+	+	++
Efficient	+		++		++

Key +++ very good; ++ good; + fair.

Source: Kopits (2018).

What are the quantitative implications of the rules for fiscal outcomes?

This qualitative assessment can be supplemented by quantitative analysis. In a simple, static setting, it is possible to assess how quickly compliance with the overall-deficit rules would bring debt to safer levels, focusing on those countries where debt is currently high. Second, it is possible to do more sophisticated modeling of fiscal outcomes based on modified versions of the World Bank's existing macroeconomic models for the six countries.

The simple analysis suggests that in some countries minimal compliance with the overall-deficit rule will not bring debt down to a prudent level by 2025. With the simplifying assumption that all changes in debt go through the deficit, we can estimate the constant overall balance needed to achieve a given debt level if we specify the future growth rate of nominal GDP.[10] Table 5 shows estimates of the balances that would be needed to achieve debt levels of 30, 45, and 60 percent of GDP by the year 2025 with nominal growth of 5 percent a year. It should be noted that this simplified and mechanical exercise is only for illustrative purposes, and the results should be treated bearing in mind this caveat. Some insights are worth presenting:

- Albania would need to run a surplus of 0.8 percent of GDP every year to achieve its debt target of 45 percent of GDP by 2025—much more than is required by the deficit rule.
- Serbia, which starts with somewhat less debt, could reach debt of 45 percent of GDP, and thus compliance with its debt rule, by running a constant deficit of 0.9 percent of GDP—a slightly tighter target than the average deficit its formula-based rule aims for.
- Montenegro would need to run overall deficits that are much smaller than the 3 percent of GDP permitted by its rule to comply with its 60 percent debt rule by 2025.
- Kosovo and Bosnia and Herzegovina are in a much better position because of their lower starting levels of debt. And while the table suggests that these two countries might appear to have room to grow their deficits, they should carefully consider the fiscal sustainability implications of higher debt levels.

Table 5. Overall Balances Needed to Achieve Selected Debt Levels by 2025
Percent of GDP

	30%	45%	60%
Albania	3.3	0.8	-1.6
Bosnia and Herzegovina	-0.7	-3.1	-5.6
Kosovo	-2.9	-5.3	-7.7
North Macedonia	1.3	-1.2	-3.6
Montenegro	3.9	1.5	-1.0
Serbia	1.5	-0.9	-3.4

Source: World Bank Staff estimates using Escolano (2018, Eq. 19) and forecasts of public and publicly guaranteed debt at the end of 2018 from the February 2019 World Bank database for the Regular Economic Report for the Western Balkans.

[10] It is more common to analyze the relationship between debt and the primary balance. We have analyzed the relationship between debt and the overall balance because, as Table 1 shows, overall-balance rules are more common than primary-balance rules in the region, as indeed they are elsewhere. Specifically, we apply equation 19 in Escolano (2010), which, rearranged and with a slight change in notation to avoid confusion with the symbols used in the current paper, states that the average overall balance, $\bar{b}$, needed to bring debt from its current level, D_0, to a given level, D_N, in N years with a nominal growth rate of GDP of γ is given by

$$\bar{b} = \frac{1}{N}\left(\frac{-\gamma}{1+\gamma}N\bar{D} + D_0 - D_N\right)$$

where $\bar{D}$ is the average debt over $t = 0, \ldots N-1$, which we approximate by assuming that debt declines linearly.

Of course, these estimates depend crucially on the assumed growth rate. Nominal growth could well be higher than 5 percent a year, which would reduce the surpluses required to achieve the debt levels shown in Table 5. For example, with annual inflation of 2 percent, the assumed real growth rate underlying Serbia's deficit rule implies nominal growth of roughly 6 percent a year. On the other hand, in the five years ending in 2018, none of the countries is expected to have achieved nominal growth as high as 5 percent.[11] Estimated by the model rates range from a low of 2.4 percent in Bosnia and Herzegovina to a high of 4.8 percent in Albania. This period was, of course, affected by the global financial crisis, and future growth may be faster.

To take account of random shocks and feedback from fiscal policy to the state of the economy, we can turn to macroeconomic modeling. This modeling, developed by Jooste, Burns, and Song (2019), is based on the World Bank's macro-econometric models for each of the six countries of the Western Balkans. Added to these models are fiscal-reaction functions that specify how the government responds to fiscal outcomes in the presence of fiscal rules. The models project the fiscal deficit and public debt, as well as other economic variables such as output and inflation. The models can be used to estimate how the economy would respond to changes in fiscal rules or to changes in the strength of the government's commitment to complying with the rules. The models allow for random shocks, and the generation of some of the results relies on Monte Carlo simulation.

The additional element of the modeling is a specification of how government spending reacts to differences between fiscal outcomes and what is permitted by fiscal rules. Specifically, with variables expressed as shares of GDP, the general approach is to determine government spending in the current year as a function of (i) last year's government spending, (ii) the difference between last year's public debt and the debt permitted by the debt rule, and (iii) the difference between last year's fiscal deficit and the deficit permitted by the deficit rule.[12] In some cases, the general approach is modified to take account of the nature of a country's particular fiscal rules.

Crucial assumptions underlying the modeling include the following:

- Government spending is the variable that adjusts to ensure compliance with the fiscal rule, and within spending it is public investment that initially bears the burden of adjustment, unless the law stipulates some other adjustment mechanism.
- Government spending tends to be sticky, so spending this year tends to be similar to spending last year; it generally does not adjust immediately to close any gap between the

[11] Nominal growth is assumed to be the sum of the arithmetic averages of the rates of real growth and consumer price inflation taken from World Bank (2018, p. 75) and depends on forecasts for the year 2018.

[12] Specifically, government spending as a share of GDP in year t, g_t, is given in the general approach by the following equation:

$$g_t = \beta g_{t-1} + (1-\beta)[\alpha + \omega(\theta_1[d_{t-1} - d^*]) + (1-\omega)(\theta_2[b_{t-1} - b^*])]$$

where d is the debt, $d^*$is the debt limit, b is the actual budget balance, b^* is the balance required by the deficit rule, and all these variables are expressed as shares of GDP, and α, β, ω, θ_1, and θ_2 are policy parameters that reflect the government's commitment to complying with the rules.

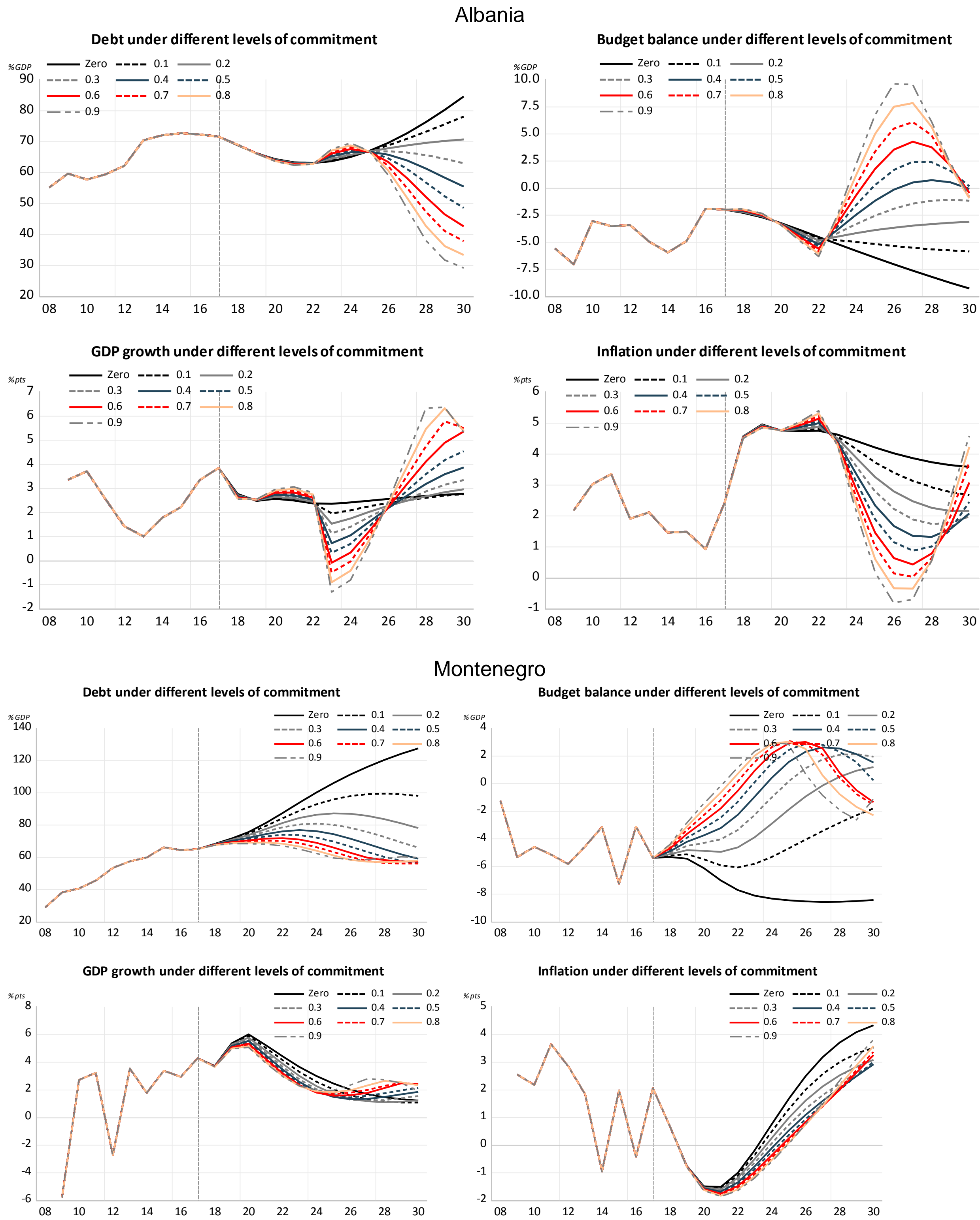
actual and permitted levels of the debt and deficit. Exactly how quickly spending adjusts depends on parameters that can be specified.

- The government is nonetheless influenced by fiscal rules, so if the debt or deficit are higher than permitted by the rules, spending will be lower than it would otherwise be. Parameters in the model determine the relative importance the government is assumed to give to compliance with the debt rule and compliance with the deficit rule and, when the debt or deficit is higher than permitted by the rules, how quickly the government seeks to close the gaps.

The modeling shows that reductions in debt can require strong commitment to compliance. Figure 4 shows how the debt and deficit of Albania and Montenegro, the countries with the highest current levels of debt, can be expected to evolve according to a measure of the government's commitment to following the rules. Specifically, commitment here means how quickly the government seeks, by cutting spending as a share of GDP, to close the gap between the permitted levels of the debt and deficit and the actual levels when they are above the permitted levels. Zero commitment (the solid black line in the chart) means that fiscal rules have no influence at all, and spending is unaffected by gaps between actual outcomes and those permitted by the rules. In this case, the deficit and debt grow explosively. By contrast, commitment of 1 means immediate compliance. Actual commitment will be somewhere in between these extremes, and the highest level of commitment shown in the Figure is 0.9. To take the case of Montenegro as an example, the modeling shows the following:

- With no commitment at all to following the rules, the deficit widens to more than 8 percent of GDP and debt rises to more than 100 percent of GDP by 2025 and continues to increase. Clearly, this path would lead to crisis.
- With commitment of 0.3, fiscal consolidation sees the deficit eliminated by 2025. This is a stronger consolidation than is required by the country's overall-deficit rule (which limits the overall deficit to 3 percent of GDP), but even with this effort, debt still exceeds 60 percent of GDP in 2025.
- With extremely strong commitment, of 0.9, debt would fall to 60 percent of GDP by about 2025, but this level of commitment implies significant surpluses, significant short-term economic costs, and would be hard to sustain.

Figure 4: Commitment and Projections of Fiscal and Economic Outcomes



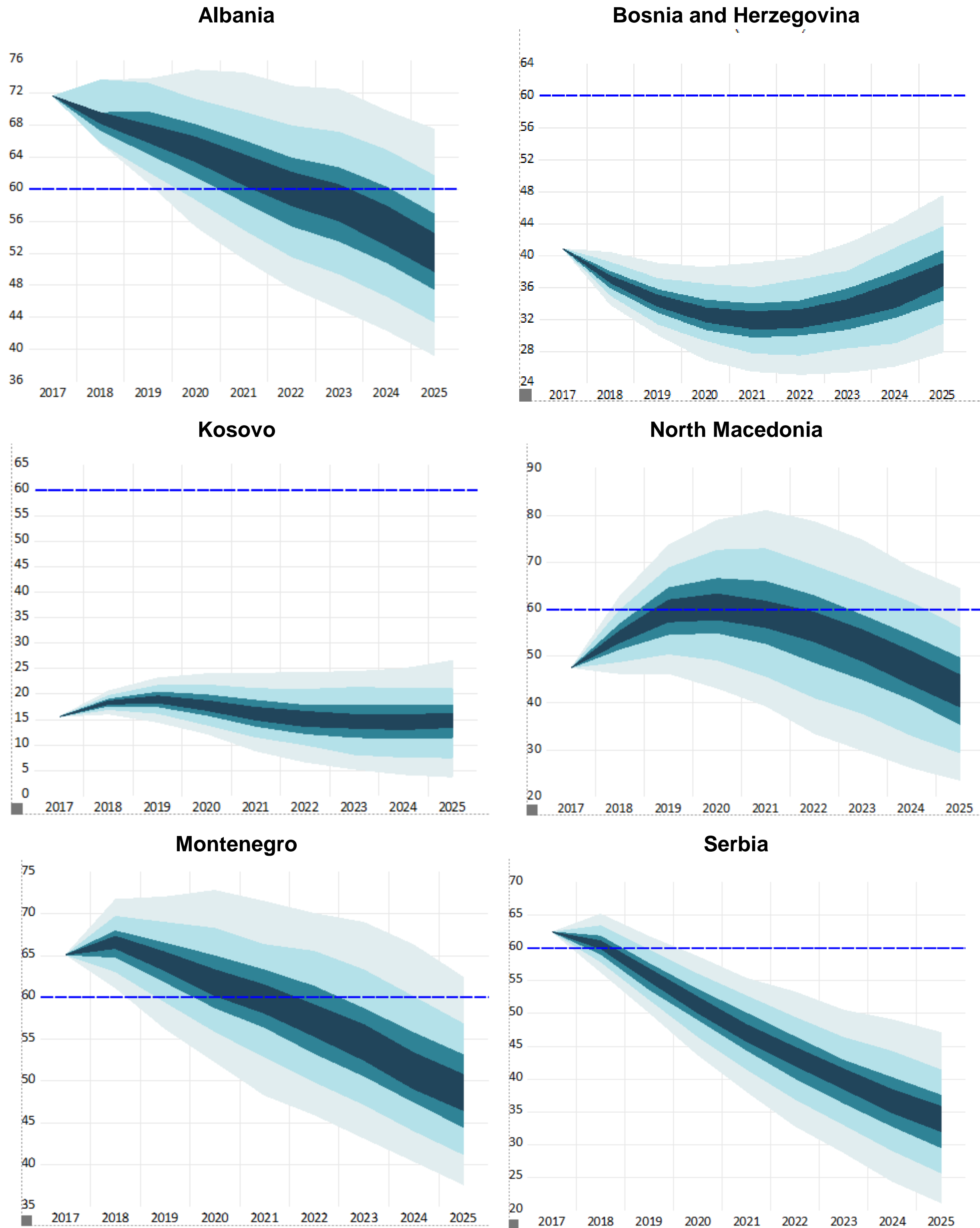
Source: Jooste, Burns, and Song (2019).

The modeling also shows the implications of commitment for inflation and GDP. Strong commitment to meeting the rules means strong fiscal consolidation, which leads to slower growth of GDP. This in turn is associated with low or even negative inflation.

Actual outcomes will depend on random shocks as well as the strength of government commitment. The modeling shown in Figure 4 is deterministic and thus does not take account of the shocks that the countries will be buffeted by. Taking a different approach, the modeling shown in Figure 5 assumes sufficient commitment to comply with the EU's debt limit of 60 percent of GDP by 2021 in the absence of shocks. For some countries, as discussed above, this means very strong commitment. What the figure reveals is the extent of the uncertainty created by the shocks. To take the case of Albania as an example, the figure shows that, by construction, the central projection is for Albania to get debt down to 60 percent of GDP by 2021, but the range of reasonably likely outcomes around this central projection is wide. At the end of the forecast horizon, for example, the 90 percent confidence band for debt ranges from about 40 to about 68 percent of GDP, and there is, by definition, a significant chance that debt will be outside this band.

Taken together, the modeling results suggest that in some countries bringing down debt to prudent levels will be difficult. In the countries that start with the lowest debt, Kosovo and Bosnia and Herzegovina, keeping debt at modest levels should be feasible, although large negative economic shocks could change this picture. The difficulty of fiscal consolidation is likely to be greatest in Albania and Montenegro, where it will require strong commitment even in the absence of negative shocks.

Figure 5: Model-Based Projections of Debt-to-GDP Ratios Given High Commitment to Rules:
Confidence Bands of 40, 60, 70, and 90 Percent



Source: Jooste, Burns, and Song (2019).

How well supported are the rules by public financial management?

Public financial management is reasonable in many respects.[13] The quality of budgets, forecasts, accounts, and statistics is hard to summarize, but in the region, there are generally:

- Functioning budgets
- Medium-term fiscal projections
- Monthly or quarterly in-year budget-execution reports
- Accounts or statistics on fiscal outcomes at the end of the year
- Detailed data on traditionally defined debt and debt guarantees (that is, on the bonds the governments have issued and the loans they have contracted, along with the guarantees they have given of other entities' bond and loans).

In many of the countries, the basic information is published in a timely and accessible manner. There are also some interesting innovations, such as the use of a fiscal council in Serbia and Republika Srpska and the use of external GDP forecasts in Albania.

But there are several problems with fiscal information.

- *Coverage of public institutions*. Statistics do not include data on all the public institutions that are part of general government according to standards such as ESA 2010 (EC 2013). For example, the recent IMF Fiscal Transparency Evaluation for North Macedonia estimates that statistics on general government should, but do not, include the activities of 12 state-owned enterprises with spending equal to about 3 percent of GDP (IMF 2018, pp. 13–14). Similarly, the Fiscal Transparency Evaluation for Albania estimated that there were about 27 entities that should have been included in data on general government, but were not (IMF 2015, p. 12).
- *Coverage of fiscal stocks and flows*. None of the central governments publishes a set of audited accrual-based financial statements according to standards like International Public Sector Accounting Standards or a comprehensive set of statistics like those required by the IMF's *Government Finance Statistics Manuals* of 2001 and 2014. None can yet produce reliable estimates of the debt and deficit as defined in the EU's standards. There are plans to gradually adopt accrual-based accounts, for example in Albania, and to improve statistics, including by generating statistics that conform to the EU's standards (for Excessive Deficit Procedure and ESA2010). But for the moment information on, for

[13] Available assessments of public financial management include Public Expenditure and Financial Accountability (PEFA) reports for Albania (World Bank 2018), Bosnia and Herzegovina (World Bank 2014); Kosovo (AECOM 2016); North Macedonia (Wiggins and others 2015); Montenegro (World Bank 2013); and Serbia (World Bank 2015); Fiscal Transparency Evaluations for Albania (IMF 2015) and North Macedonia (IMF 2018), as well as older IMF fiscal ROSCs for some of the countries; and IMF Staff Reports for the countries, which contain comments on the adequacy for surveillance of government-finance statistics in each country. Public Finance (or Expenditure) Reviews also include sections on public financial management, including recent ones for Albania (World Bank 2014), North Macedonia (World Bank 2015, 2018), and Serbia (World Bank 2015).

example, government assets and non-debt liabilities is usually inadequate, and accrual-based measures of the deficit are unavailable. Good information tends not to be routinely available on accounts payables, arrears (overdue accounts payable), nonfinancial assets, pensions liabilities, and obligations in concessions and other public-private partnerships.

- *Forecasting*. In at least some countries, economic and fiscal forecasting has had an optimistic bias,[14] though this problem may be less acute than before. Albania, Serbia, and Republika Srpska have taken steps to solve this problem by using external forecasts or review by an independent fiscal council.
- *Medium-term planning*. Similarly, although medium-term spending plans are prepared, they do not always have the influence they are intended to have in the preparation of annual budgets. Possible reasons for this include optimistic revenue forecasts, which encourage spending plans that are themselves unrealistic; investment plans that cannot always be implemented; the major shocks created by the global financial crisis; and a widespread belief that medium-term spending plans will not in the end matter much and are therefore not worth preparing very carefully.

Quantitative indicators paint a similarly mixed picture. Scores on the Open Budget Index—which run from 0 to 100, where 100 is ideal—range from 35 in Bosnia and Herzegovina to 50 in Albania, with no scores available for Kosovo or Montenegro (Table 6). Scores for the comprehensiveness of government-finance statistics submitted to the IMF by 2013, which also run from 0 to 100, range from 5 in Montenegro to 21 in Serbia, with no score available for Kosovo. Recent Fiscal Transparency Evaluations for Albania and for North Macedonia do not result in numerical scores but suggest moderate performance. PEFA scores for expenditure outturns, which indicate the extent to which aggregate on-budget spending is controlled, are good, but scores for medium-term fiscal planning, expenditure arrears, and the extent of central-government operations outside financial reports are mostly poor, Kosovo's scores being an exception.

Table 6. Selected Indicators of the Quality of Supporting Aspects of Public Fiscal Management

	Open Budget Index 2017	GFS submitted to IMF	Medium-Term Fiscal Planning (PEFA)	Expenditure Outturn (PEFA)	Expenditure arrears (PEFA)	Operations outside financial reports (PEFA)
Albania	50	16	C+	A	C+	D
Bosnia and Herzegovina	35	13				
Federation of B and H			D+	A		D+
Republika Srpska			D+	A		D+
Kosovo	..	..	C	B	C+	A
North Macedonia	37	6	D	B	D+	C+
Montenegro	..	5	C	B	C+	D+
Serbia	43	21	C	B	D+	

Sources: International Budget Partnership; Wang, Irwin, and Murara (2015); latest PEFAs.

[14] For Albania, for example, see, for example, World Bank (2014, ch. 5) and IMF (2015). For Serbia, see World Bank (2015). For Montenegro, see World Bank (2019).

These problems frustrate the effective implementation of fiscal rules:

- The incomplete coverage of general government makes the rules less effective. It may also make future compliance with the EU's fiscal rules more difficult than it may it first appear, since Eurostat will examine the coverage and may conclude that it should be broader than it currently is. Similarly, the absence of accrual accounts will make compliance with the EU's accrual-based deficit more difficult—though there are procedures for estimating accrual deficits on the basis of cash data.
- There is too little information to show whether the letter of the fiscal rules has been followed only by violating their spirit. For example, have the rules been complied with only by allowing arrears and other accounts payable to accumulate? Or have they have been complied with only by moving public spending and borrowing to state-owned enterprise and other entities not included in the scope of the rules?
- Problems in forecasting and medium-term fiscal planning also make it harder for governments to comply with the rules and, if compliance is nevertheless achieved, may encourage abrupt rather than smooth adjustments.

V. PRINCIPLES TO GUIDE POLICY TOWARD FISCAL RULES

What principles should guide policy toward fiscal rules in the Western Balkans? Although the evidence about the effectiveness of fiscal rules is not robust enough to support confident recommendations, the following five principles can help guide policy in the period ahead.

First, the fiscal rules should enjoy strong domestic support. That in turn means they should be simple and introduced only after considerable public debate. Because self-imposed national fiscal rules work partly by changing political pressures, they work best if they are clearly understood by politicians and the population at large and enjoy support across party lines (e.g., Schick 2004). This suggests that the rules should be simple and few in number; introduced after careful public debate; enacted in a legal norm that requires a supermajority to pass or amend; and changed only occasionally. Governments can, and should, have more fiscal goals than compliance with fiscal rules; these additional goals, which can vary with the state of the economy, should be set out as targets in budget documents or medium-term plans—not in a law intended to be permanent. Although the press can be expected to report on whether the government has complied with fiscal rules so long as the rules are announced with enough fanfare, having an independent fiscal institution monitor and report on compliance can raise the quality of public debate on the subject.

Second, the rules in place should ease accession to the EU. National fiscal rules should be consistent with EU rules. But the rules do not need to be identical to the EU's to be consistent with them. Debt limits should be less than 60 percent of GDP, and the total set of rules should be simpler than those of the EU. The focus should also be on changes that will not be regretted if accession to the EU is delayed.

Third, the systems of public financial management that support fiscal rules should continue to be improved. These improvements are among those most likely to pass the no-regrets test. Being able to measure the government's debt and deficit according to the rules of ESA 2010, for example, is necessary if the countries are to join the EU, but it will be valuable even if they do not. Being able to monitor debts and deficits according to these rules will, for example, make it easier to see if fiscal rules are being followed only at the expense of a build-up of arrears or the transfer of spending responsibilities to noncommercial state-owned enterprises. Once ESA data can be measured with sufficient reliability, they can be used for setting fiscal rules or targets. Ensuring that forecasts are unbiased is also valuable, and it will be useful to evaluate the success of attempts to get unbiased forecasts by establishing fiscal councils. Solving the problem of biased forecasts will also increase the prospects for making medium-term spending plans credible. Spending reviews of the kind used in many EU countries can ensure that across-the-board spending restraint is supplemented by periodic, in-depth examination of whether spending is efficient and well-targeted.

Fourth, limits should not be mistaken for targets. To adopt a debt limit of, say, 60 percent of GDP is not to say that government should aim to keep debt at or just below 60 percent of GDP. Most of the time, it may be prudent to aim for much less debt. One way of trying to distinguish rules from targets is to combine rules with clearly announced but nonbinding targets that are tighter than the rules. If the rule says that debt may not exceed 60 percent of GDP, for example, the government can announce a target of, say, 40 percent. Or, if the rule says the deficit can never exceed 3 percent of GDP, the government can announce that in good years it will aim for surpluses.

Fifth, the rules should both set a long-term objective and give clear short-term guidance. Recent work on fiscal rules (e.g., Eyraud and others 2018 and IMF 2018) notes that fiscal rules need to be considered collectively and suggests that the best approach is to combine a long-term fiscal objective with a rule that specifies minimum progress in the short term toward that objective. The long-term objective is typically specified in terms of a fiscal stock, most often gross debt. The long-term objective is chosen to promote fiscal sustainability and minimize the risk of a fiscal crisis. The rule that governs policy in the short term puts a limit on a flow variable, such as the overall deficit, in a way that ensures a degree of progress toward the long-term stock objective. Albania's fiscal rules have this form, though the flow rule, as noted earlier, may not be the best. Probably better is a deficit or expenditure rule. While revenue matters as much as expenditure to fiscal outcomes, expenditure rules are attractive because expenditure is easier to control than revenue, and expenditure rules allow room for countercyclical fiscal policy. A good set of rules also adjusts the short-term objective according to prior progress. In particular, if the long-term objective has gotten further away, perhaps because of a recession, the short-term rule generally requires quicker future progress toward the objective.

Appendix: Questionnaire

1. Which of the following best describes your current affiliation?

Media
Academia
Public sector
Private sector
Other (please specify)

2. Select the country you currently live in:

Albania
Bosnia and Herzegovina
Kosovo
North Macedonia
Montenegro
Serbia

3. Are you concerned about the fiscal situation in your country?

Yes ->Q4 No

4. What are the concerns you have about fiscal situation in your country?

[Open answer]

5. Do you understand the definition of the fiscal rule in your country?

Yes. It is a quantitative rule that prescribes limits on the fiscal deficit, public debt, or public expenditure levels embedded in the constitution, the organic budget law or a separate law on fiscal responsibility, monitored by the independent fiscal council.

Yes. It is an annual fiscal deficit target embedded in the annual budget law.

Yes. It is the medium-term fiscal deficit and the debt target as planned in the government annual fiscal strategy.

Yes. All of the above.

No, I don't understand.

6. Does your country have any fiscal rule?

Yes No -> go to Q20

7. Could you please select all the rules that you are aware of that exist in your country?

Public and publicly guaranteed debt to GDP ratio planned for each budgetary year is lower than for the previous year, until debt reaches and remains below 45% of GDP.

Public debt must be below 55% of GDP or current expenditures need to be reduced until general debt reaches 55% of GDP.

Consolidated budget deficit must not exceed 3% of GDP.

If public debt reaches 50% of GDP, the budget for the following year must be in surplus.

If the consolidated budget deficit reaches 2.5% of GDP, the budget for the following year must be in surplus.

Central budget deficit must not exceed 2% of forecasted GDP and public debt must be below 40% of GDP.

General government debt must not exceed 60% of GDP and guarantees 13% of GDP.

General government deficit must not exceed 3% of GDP.

Expenditure growth must be lower than GDP growth. General government debt must not exceed 45% of GDP.

The maximum deficit depends on real and potential GDP growth and last year's deficit.

Other (please specify)

8. Does the government comply with the fiscal rules that are in force in your country?"
Yes ->Q10 No -> Q9

9. Why the fiscal rule is not complied with?

There is a high public spending on the public-sector wage bill and other current spending categories

A lot of tax exemptions and low tax collection

Excessive capital spending
The fiscal rule is being circumvented by delaying infrastructure maintenance, building of arrears or interference in statistics
Other (please specify)

10. Who monitors compliance with the fiscal rules in your country?
Parliament
State audit office
Fiscal Council
Ministry of Finance
Other (please specify)

11. Have you ever read the report of the fiscal rules monitoring body in your country?
Yes ->Q13 No -> Q12

12. Why haven't you read the reports of the fiscal rules monitoring body?
I am not interested in reading them.
They are not publicly available.
They are not publicly disseminated.
Other (please specify)

To Q 18

13. How did you access the report of the fiscal rules monitoring body?

Through the website of that body
Press report
Annual budget report
State audit annual report

14. Do you understand the findings of the reports on the fiscal rule compliance?

Yes -> Q16 No -> Q15

15. Why?

They are not written in an easy to understand manner.
I do not understand the fiscal rule definition in my country.
Other (please specify)

16. Do you find the report on the fiscal rule compliance credible?

Yes -> Q18 No -> Q17

17. Why?

Fiscal data are circumvented to satisfy the rule.
I do not trust the institution that wrote it.
Other (please specify)

18. Do you believe that the existing fiscal rules in your country contribute to more prudent budgeting, improve government fiscal performance and accountability?

Yes -> Q20 No -> Q19

19. Why?

[Open answer]

20. What fiscal rule would you recommend introducing in the country and which independent institution should be monitoring the rule?

21. What would be your recommendations for further improving fiscal rules and would the establishment of an independent fiscal council lead to more prudent fiscal policy?

Open question

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