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A CASE FOR INTRODUCTION OF NUMERICAL FISCAL RULES IN SERBIAN CONSTITUTION

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FISCAL COUNCIL – REPUBLIC OF SERBIA

A CASE FOR INTRODUCTION OF NUMERICAL FISCAL RULES IN SERBIAN CONSTITUTION

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Abstract

The paper recommends that simple and straightforward numeric fiscal rules should be in introduced in the Constitution, i.e. that constitutional fiscal rules should be introduced in Serbia. Two cumulative numerical fiscal rules are suggested. The primary one is about the ceiling of the sovereign debt and the secondary one is about the ceiling on net new borrowing. Neither of the rules can be violated. The ceiling on the debt level should be predetermined by the Constitution. The ceiling on the new net borrowing should depend on the distance of the sovereign debt to the debt ceiling. An illustrative example with the debt ceiling of 80% is provided. Nonetheless, a specific sovereign debt ceiling as a part of constitutional amendments proposal should be specified by the Fiscal Council, taking into account projections of the fiscal deficit and debt sustainability analysis – the contribution remains silent on the specific constitutional debt ceiling for Serbia.

JEL Classification: H61, H62, H63.

Keywords: Fiscal rules, constitution, sovereign debt, fiscal deficit, Serbia

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1. Introduction

Sustainability of public finances and especially sovereign debt has become one of the most important topics in Europe in the aftermath of the global financial crisis. To some extent, diverging fiscal situation across European countries reflects their different political and electoral institutions, their history and culture, but to some extent it is also a result of their economic performance and fiscal institutions.

Over the last decades many European countries have introduced fiscal rules and have established independent fiscal agencies in order to strengthen their budgetary process and improve fiscal outcomes. Some countries have done it through adopting special laws, while many countries have amended their constitutions. For example, the Polish Constitution explicitly prohibits public debt higher than 60% of GDP, while Germany and Switzerland have introduced so called "debt break" provisions in their constitutions.

Serbia has also introduced fiscal rules in 2010 through amendments to the Budget System Act by limiting public debt-to-GDP ratio to 45% (excluding future restitution claims) and by introducing the allowed deficit formula. It is obvious, nonetheless, that neither of these rules were implemented after the adoption – the debt rule was broken within a year of its introduction and the deficit rule was not followed in any single year. It seems that the main reason for ineffectiveness of the fiscal rules was the fact that a law simply cannot limit the power of the National Assembly to adopt another law – for example whatever annual Budget Law it wants. Only constitutional constraints may be effective in this case.

Nonetheless, the Serbian Constitution is almost completely silent on the fiscal issues. It only stipulates that all revenues and expenditures have to be presented in the budget and that Republic of Serbia (and other levels of authorities) may borrow. The main hypothesis of this paper is that the Constitution should be amended to contain more detailed provisions regarding fiscal policy – basically constraints to that policy. The aim of this paper is to test this hypothesis and explore what should be the elements of these constraints, i.e. to propose the content of the amendments.

Accordingly, the first section of the paper offers a literature review as to the reasons for constraining Government's discretion in issues of fiscal policy. Then the experience regarding legal constraints to the fiscal policy of several relevant countries is explored. In the following section the current fiscal responsibility legal framework in Serbia is analysed altogether with its shortcomings. Finally, a proposal for Serbian constitutional amendments is provided and discussed.

2. Literature overview

The literature has identified a number of reasons for introducing rules, i.e. constraints in the fiscal-policy making and not simply letting democratically-elected parliaments to freely adopt

any fiscal policy.[1] Most of these reasons have something to do with either irrationalities or rational biases present in the policy making, whether on the side of policy makers, or on the side of voters ("Deficit Bias"). Schuknecht (2004) has identified several sources of deficit bias, such as: (1) fiscal illusion; (2) election cycles; (3) asymmetries in the allocation of costs and benefits and/or distributional conflicts among interest groups; and (4) common pool problems (tragedy of the commons).

Fiscal illusion is the phenomenon that voters are not fully aware of the tax costs of some public policy. Taking into account that voters may have a clear benefit from some public policy, but that costs are hidden or even invisible, this situation leads voters to demand an increase of public expenditures from the politicians. According to Dollery and Worthington (1996), there are several different causes of fiscal illusion.

Fiscal illusion can be a consequence of fragmented tax system. The seminal model was developed by Wagner (1976). His main thesis is that taxation systems become more complex and more diversified with the goal to hide total tax burden from the citizens. As a result of such diversification, the ordinary citizen can no longer assess full tax cost of a public policy as such assessment is literally impossible. Wagner was also able to empirically confirm that increased complexity of tax system *ceteris paribus* leads to increases in government expenditures.

Related to this is the so called phenomenon of "renter illusion" (Blom-Hansen, 2005). Taking into account that in the US most of the local fiscal revenues are coming from property taxes (which are paid by the property owner) "renter illusion" hypothesis is that in municipalities where share of renters (lessees) is higher, the public expenditures will also be higher as renters do not realize that they are the ones actually paying the property taxes through higher rent. This can off course be generalized to other similar cases (for example, consumers supporting higher corporate profit tax without understanding that a likely result will be an increase in prices).

Secondly, fiscal illusion is more pronounced at the levels of government which rely more heavily on transfers from other levels of government and public expenditures are therefore higher. The logic is that if taxpayers are not aware of the full cost of public expenditures (due to the fact that they are partially being financed by transfer, i.e. by someone else) the demand for government consumption will grow, as demonstrated by DiLorenzo (1982b), Winer (1983), Logan (1986) and Grossman (1990).

Finally, if the government can borrow money, fiscal illusion can be especially augmented as voters are not fully aware of the future rise in taxes and even if they are, their intertemporal preferences could be strongly in favour of current consumption.

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[1] The rationale for such constraints is found in the insight that excessive public debt produces negative effects to economic growth. This insight is accepted as a basic assumption of this paper, i.e. a rationale for the constitutional constraints of fiscal policy. The recent insights on the issue (Kumar and Woo, 2010, Cecchetti, Mohanty, and Zampolli, 2011, and Reinhart, Reinhart, and Rogoff, 2012) provided overwhelming evidence about negative effects of public debt over 85%-90% of the GDP to economic growth, reducing it by 1%. Nonetheless, there are some second thought about these results regarding the causality in the case of the OECD countries (Panizza and Presbitero, 2014) and the exact level of threshold for the growth deceleration (Egert, 2015).

Elections cycles can also be a source of deficit bias and fiscal policy instability as there is a clear incentive for elected politicians to implement expansive fiscal policy prior to elections. Many different economic models have been developed to analyse the links between political and economic cycle. Nordhous (1975) starts from the premise that democratically elected politicians heavily discount public consumption after the election. In turn, while private investors prefer to sacrifice short-term consumption for long-term investments and consumption, public investors (i.e. elected politicians) do not usually behave in such a way. So, it should be expected that periods before elections will be the periods of expansive fiscal policy, but we can only hope that period after the elections will be more restrictive.

This bias should be in addition considered within the framework of time inconsistency. It is a phenomenon that due to changing preferences over time, preferences become inconsistent in the future (Kydland and Prescott, 1977). For example, one of the main problems for monetary policy was reducing inflation in democratic governments. Namely, politicians were promising lower inflation in the future, but once the future comes reduction is further delayed due to short term risk of higher unemployment. That was one of the reasons for introduction of independent central banks, based on the belief that central banks, which are not under political pressures to increase growth and employment in the short term, will more easily and more credibly enforce low inflation policy. It is evident that similar phenomenon exists in the case of fiscal policy in which most of the actors agree that debt should be reduced, but "in the future". And yet, when the future comes, fiscal responsibility is further delayed.

Another source of deficit bias is due to asymmetry of allocation of costs and benefits. It is not the case that a single tax payer receives the benefits from spending at the amount of his/her tax burden. It is interest groups that have strong incentive to increase benefits from spending to their members. Interest groups use various advocacy mechanisms and lobbying to influence public policy. Their primary goal is to make the government to implement such a policy which would directly benefit the interest groups' members, while costs would be spread over millions of uninformed and unorganised tax payers/voters.[2] Such separation between costs and benefits can easily lead to over spending. Having in mind that budgetary decisions are made by politicians whose primary goal is to be re-elected, political support from the well organised small groups can be more important than support from unorganized and uninformed constituency. Therefore, politicians are incentivized to redistribute resources towards well organized groups, increasing public expenditures, as demonstrated by Olson (1965).

It was also demonstrated that budget process suffers from the common pool problem (Alesina and Perotti, 1996, and Von Hagen 2008). From the point of view of the executive power (ministers), the budget is a common pool – although there is rivalry in consumption (an amount of money spent on one ministry cannot be spent on the other), costs are distributed among all the ministries, i.e. the whole executive government. The same goes for the legislative power, as the representatives have incentives to increase/maximise public expenditures in their own

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[2] Single-issue political parties, like pensioners parties, can be considered as interest groups organized as a political party, as there are interested only in increasing specific public expenditures benefits, focused to the member of that interest group, i.e. supporter and voters of that political party. The political party framework enables them to overcome the free rider problem effectively, so these parties can represent rather big interest group.

constituencies, without taking care what are the effects of these expenditures on the budget as a whole. Furthermore, the exclusion of those with huge public expenditures on their agenda is not feasible, save a political agreement among those who have incentives to spend more. Hence, the main problem is that all public expenditures are financed from the common pool (budget) and those making decisions have every incentive to increase expenditures for their own constituency, thus increasing overall public consumption.[3]

The literature overview shows that there is an academic consensus that deficit biases are a real world phenomenon and that some limits should be imposed on decision makers in order to reduce space for unconstrained decision making. Also, an incentive mechanism should be in place which would penalize irresponsible behaviour and promote responsibility. For example, higher transparency of public finances allows voters to obtain the data on which they can base their voting decision.

Besides transparency, constraints can take other forms. First group is comprised of numerical fiscal rules which set limitations and targets on some fiscal aggregates (deficit, debt, expenditures, revenues, etc.). This, for example, is one way to make the political decision-makers to view the broad picture, i.e. to take into account the common pool issue –by introducing the formal rules. It is essential that these rules are procedural and permanent or at least enduring, i.e. being very difficult to be changed. Only in that way rules can help to solve the problem of time inconsistency, if they are hard, i.e. if they cannot be easily changed in time. If the rules can be changed, they can also become time inconsistent. That is why it is reasonable to make changing the rules more demanding, for example by constitutionalising it.

The second group of constraints is consisted of procedural rules, usually defined in constitution or organic legislation. They usually concern the issues of budget adoption (by simple or qualified majority), budget execution reporting, budget amendment initiatives, etc. Third group of constraints is related to the introduction of specialised independent institutions to which some part of the fiscal policy is delegated.

As the literature has been reviewed it demonstrates that there is an academic consensus on the necessity for persistent fiscal rule, i.e. the rule that will decrease the risk of continuous fiscal deficit and excessive sovereign debt. That consensus has been established even before the Great Financial Crises of 2008. The crises itself just amplified the need for constraining fiscal deficit and sovereign debt. That is one of the factors that influenced the advent of the formal legal fiscal constrains in the EU countries.

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[3] It should be expected that this kind of the common pool problem among legislators does not exist in the case of pure for proportional representation, i.e. with only one constituency and closed list of candidates. Nonetheless, the common pool problem arises with the advent of single issue parties with well-defined constituency (i.e. enhanced interest groups), though not territorial, like the pensioners parties in the transition economies. Furthermore, the common pool problem remains in the executive branch of the movement and it is augmented with coalition government with ministers from different political parties. In this case there are strong incentives for the ministers to increase public expenditures within its ministry to boost the political ratings of their own political party – common pool problem is aggravated.

3. Constitutional responses to the fiscal deficit and public debt in the EU

3.1. Supranational level

Even before the most recent sovereign debt crises, EU had an elaborate set of rules regarding fiscal affairs of member states. For example, two (criterion 2 and criterion 3) out of five criteria set out in the Maastricht Treaty (signed in 1992) can be considered to be “fiscal rules”:

- ratio of the planned or actual government deficit to gross domestic product (GDP) shall not exceed 3%, and
- government debt to GDP shall not exceed 60%

As a way of operationalising these targets, Stabilization and Growth Pact (SGP) was signed in 1997, with the main goal of providing incentives for complying with the rules and for disciplining the member states. Some of the envisaged measures and mechanisms were the prohibition of deficit financing by the European Central Bank or the central banks of the Member States (Article 123), the explicit provision that neither the European Union nor any Member State shall in any way be liable for the debts of other Member States (Article 125), as well as prescribing the procedure for excessive deficit (Article 126). Also, SGP introduced procedures for coordination and surveillance of national economic policy (Article 121).

However, these rules were abandoned *de facto* in 2003, when the Council failed to engage the procedure for excessive deficits against two largest Member States (Germany and France) amid apparent violations, and although the Commission made the necessary initiation. The Commission then launched a case before the European Court of Justice against the Council, which in effect represented the end of the Pact and marked the beginning of work on a new treaty. Until that point, the Pact has mostly considered successful, although to a large extent that was the result of the viable economic growth, i.e. expansion (boom) in the late 1990s.

After the failure of the first Pact, it appears that EU learned two lessons.

(1) Maximum deficit of 3% of the GDP is probably too strict in recession, but is also too loose in boom period. Specifically, if a fiscal deficit is 3% in expansion period, it is very difficult (if not impossible) to keep the deficit at the same level if the recession starts. Therefore, it is necessary to make stricter requirement in expansion times and/or relax the criteria in terms of the apparent recession.

(2) The second lesson was that the existing rule is very difficult to apply to big member states, especially if they coordinate fiscal policies. Previously, Portugal and the Netherlands had to proceed with the recommendations of the Commission and implement very painful fiscal adjustment in the relatively poor economic conditions. But, when the deficit ceiling was crossed by France and Germany in 2002 (and stayed above the ceiling for two full years in case of France and four years in case of Germany), they were not penalized despite the Commission's proposal. They simply relied on their political clout and the Council did not support the Commission's proposals.

The debate on the reform of the SGP began in 2004, and the new SGP was adopted in 2005 with the main objective to make the rules more flexible. This was primarily done in three ways: 1)

medium-term objectives should be different from country to country, depending on the circumstances; 2) deficit objectives should be structural (to take into account the stage of the business cycle and should not take into account one-off factors) and 3) must take into account the level of public debt. This agreement was criticized by ECB because it doubted its power to force member states to conduct a responsible fiscal policy. However, the boom at the time (just like when the initial SGP started to be implemented) made its shortcomings hardly visible

With the advent of global financial crises in 2008, the revised plan showed all of its weakness. Member States have reacted differently to the recession – some have begun to implement major fiscal stimulus programs, while others (such as Germany) implemented more conservative policies. At one point even the European Commission called member states to act together to produce a "common EU stimulus" in effect sending invitation to the member states to break the rules. Although not formally, this has *de facto* ended the second SGP.

The SGP was changed again in 2011, (accompanied by adoption of so called “six-pack” of EU regulations), with the basic idea to remedy the perceived problem and prevent further accumulation of public debt, which was the main cause of the euro zone crisis. These new rules introduced additional criteria for reducing public expenditure if debt levels were above 60% of GDP. Also, the Commission proposal for the implementation of the Pact can only be refused by a qualified majority in the Council, which was seen as a significant strengthening of sanctions (formerly the Council had to actively vote for sanctioning). Finally, in 2013 introduced an additional package of two additional regulations (“two-pack”). According to these rules, euro zone members must submit draft budget to the European Commission before they are adopted by Parliament and the Commission has the right to request changes if it considers that budgets violated the rules of the GDP, or that there is a high risk of that outcome.

But, most important for the debate on constitutional fiscal rules is that by signing the Fiscal Compact[4] Eurozone members have committed themselves to adopt binding rules (preferably by amending their constitutions), which will commit them to a balanced budget, including automatic corrective mechanism if the fiscal deficit is too high.

Article 3 of the Fiscal Compact prescribes the following:

- Paragraph 1 stipulates that “the budgetary position of the general government of a Contracting Party shall be balanced or in surplus” and this is “deemed to be respected if the annual structural balance of the general government is at its country-specific medium-term objective, as defined in the revised Stability and Growth Pact, with a lower limit of a structural deficit of 0.5 % of the gross domestic product at market prices.” It also allows temporal deviation from the medium-term objective but “only in exceptional circumstances”, defined in Paragraph 3 as “unusual event outside the control of the Contracting Party concerned which has a major impact on the financial position of the

[4] Fiscal Compact is an international agreement signed by all EU member states, save the Czech Republic and the United Kingdom effective from the beginning of 2013, whose purpose is strengthening of mechanism of economic and fiscal coordination and control of the signatory member states.

general government or to periods of severe economic downturn", but "provided that the temporary deviation of the Contracting Party concerned does not endanger fiscal sustainability in the medium-term". Also, when the government debt is "significantly below 60%" of GDP the lower limit of the medium term objective can be increased to 1% of GDP.

- Paragraph 2 stipulates that these rules "shall take effect in the national law of the Contracting Parties at the latest one year after the entry into force of this Treaty through provisions of binding force and permanent character, preferably constitutional, or otherwise guaranteed to be fully respected and adhered to throughout the national budgetary processes."

In summary, the most recent SGP mandates that all signatories should introduce binding rules with the goal of having at most 0.5% of the GDP budgetary deficit in the medium term.

The resulting EU framework is very complex and lacks transparency. The Network of EU Independent Fiscal Institutions has in late 2015 published a position paper, calling for simplicity, improved transparency and clearer implementation rules.[5]

3.2. EU member states

Many EU member states have introduced fiscal rules in their constitutions, either as a result of the Fiscal Compact, or on their own political initiatives.

a) Poland

Constitution of Poland (adopted in 1997) has the following provision (Article 216, point 4):

It shall be neither permissible to contract loans nor provide guarantees and financial sureties which would engender a national public debt exceeding three-fifths of the value of the annual gross domestic product. The method for calculating the value of the annual gross domestic product and national public debt shall be specified by law.

Effectively, there is a ceiling on the public debt at 60% of GDP, but there is no deficit rule. Basically, the Constitution bans additional sovereign borrowing after the debt ceiling is reached, but there are no limitations on deficit at lower levels of public debt. A simple rule, definitely easy for implementation. Then technical details necessary for the rule implementation, i.e.

[5] The evaluation includes that streamlining fiscal rules is necessary, because the current system has become too complex hindering its transparency, communication and ultimately putting at risk its effectiveness and credibility. Most recent reforms of the EU fiscal governance framework have resulted in a maybe too high number of fiscal rules, EU level and national rules. Consistency across rules is not fully guaranteed. Rules are becoming increasingly sophisticated: sometimes based on too complex methodologies (difficult to understand for the general public) or even requiring interpretation agreements or decision trees for policy makers. Changes in these methodologies and secondary legislation are too frequent (not always well understood or casting doubts on the true reason behind those amendments). Transparency on these methodologies and procedural understandings is limited. For more see: http://www.rozpoctovarada.sk/download/position_paper_final.pdf).

calculations are stipulated by law. This is no doubt a reasonable solution, but the devil is frequently in the detail and there is still some latitude for manipulation in the calculation process of debt/GDP ratio.

b) Germany

The FR of Germany has also introduced a fiscal rule in its Constitution, in the form of so called "debt brake" in 2009. The rule is much more complex than in Poland. The provision (Article 109, point 3) is:

The budgets of the Federation and the Länder shall in principle be balanced without revenue from credits. The Federation and Länder may introduce rules intended to take into account, symmetrically in times of upswing and downswing, the effects of market developments that deviate from normal conditions,… Details for the budget of the Federation shall be governed by Article 115 with the proviso that the first sentence shall be deemed to be satisfied if revenue from credits does not exceed 0.35 percent in relation to the nominal gross domestic product. The Länder themselves shall regulate details for the budgets within the framework of their constitutional powers, the proviso being that the first sentence shall only be deemed to be satisfied if no revenue from credits is admitted.

Therefore, Germany does not have a national debt ceiling, but has introduced a deficit ceiling of 0.35% of the GDP on the national level and 0% on the Lander level. However, the rule says that the Federation and Lander may adopt rules which "take into account… the effects of market developments that deviate from normal conditions." So, effectively German Constitution has introduced a rule that limits the structural deficit at 0.35% of the GDP. The rules that separates total and structural deficit are always complicated and they inevitably provide ample latitude in interpretation. Furthermore, efficient and reliable statistical office is needed for implementation of these rules. That condition is doubtless fulfilled in the case of Germany, but an open mind should be kept for many other countries.

c) Spain

Spain has also recently (in 2011) amended The Constitution by changing the Article 135, which now reads:

1. *All public administrations will conform to the principle of budgetary stability.*
2. *The State and the autonomous communities may not incur a structural deficit that exceeds the limits established by the European Union for their member states. An Organic Law shall determine the maximum structural deficit the state and the autonomous communities may have, in relation to its gross domestic product. Local authorities must submit a balanced budget.*
3. *The State and the regions must be authorized by law in order to issue Public Debt bonds or to contract loans…*

Again it is the structural deficit that is targeted by this fiscal rule, though the target itself is, except for the local authorities specified by the EU – in this moment this is structural deficit of 0.5% of the GDP. Nonetheless, referring to the Article 3, Paragraph 1, of the Fiscal Compact

demonstrates one of the weaknesses of deficit control – need for exception for the rule, i.e. conditions in which the rule is not applied. This features inevitably undermines the constraint.

d) Slovenia

Slovenia has also amended the Constitution in 2013 and Article 148, paragraphs 2 and 3 stipulates the following:

- *Revenues and expenditures of the budgets of the state must be balanced in the medium-term without borrowing, or revenues must exceed expenditures. Temporary deviation from this principle is only allowed when exceptional circumstances affect the state.*
- *The manner and the time frame of the implementation of the principle referred to in the preceding paragraph, the criteria for determining exceptional circumstances, and the course of action when they arise, shall be determined by a law adopted by the National Assembly by a two-thirds majority vote of all deputies.*

By setting the target to high, to zero structural deficit, specified as medium-term deficit, the attention of the budgetary process is than inevitably focused to the exceptional circumstances. Specification of these circumstances (as well as specification of the medium-term) is left to the law and the only special feature of this law is that it must be adopted or amended by a two-thirds majority vote of all deputies. Effectively that creates law based constraints, i.e. numerical fiscal rules rather than constitutional constraints.

e) Slovakia

In 2011 Slovakia has adopted a Constitutional Law on Fiscal Responsibility which has introduced numerical fiscal rules. Most importantly, sovereign debt is limited at 50% of GDP, but the Law also envisages some corrective measures at 40% of debt-to-GDP ratio. There are five measures which escalate, starting from a letter that Minister of Finance has to send to the Parliament, all the way to confidence vote in the Parliament.

The law envisages the following measures (numerical targets refer to the period up to 2017, and after that all the targets are reduced by 1 percentage point per year):

1) If the debt is between 50% and 53% of gross domestic product, the Ministry of Finance must provide a letter to the Parliament with a written explanation as to why there has been an increase in debt, as well as proposals for measures to reduce debt.

2) If the debt is between 53% and 55% of gross domestic product, the government must submit a proposal to Parliament of measures to reduce public debt and reduce the salaries of Ministers to the level of the previous year.

3) If the debt is between 55% and 57% of gross domestic product, the Ministry of Finance must prevent disbursement of 3% of all budget expenditures (excluding expenditures for debt repayment, the EU funds, transfers to EU funds and transfers to the Social Insurance Agency). At the same time, the Government cannot submit a budget proposal to the Parliament that would envisage a nominal increase of total government

expenditure (except in the aforementioned categories), and local authorities must submit budgets with the same nominal amount as last year.

4) If the debt is between 57% and 60% of gross domestic product, the government is has to provide a balanced budget proposal to the Parliament, and the same applies to municipalities.

5) If the debt is above 60% of GDP, despite all the measures listed above, the Government has to face confidence vote in the parliament.

The measures are cumulative. For example, if the debt is higher than 60% of GDP all of the above measures apply, except the 3% cut in expenditures, which is conducted only once when the debt exceeds 55% of GDP. The law also provides very clear exceptions to these rules. In addition to the usual provision that fiscal rules do not apply in the period of war, measures that are supposed to be activated at 5% below the maximum allowable debt do not apply in the cases specified by the law.

As to the basic concept both numerical control of deficit and debt are used. It is reasonable for the macroeconomic view of point that only structural deficit is controlled, this deficit control rules are inevitably rather complicated and various exceptions must be envisaged. These exception can be easily abused. Taking that into account, it seems that preferable solution would be numerical control of debt. A promising concept could be debt control as the primary fiscal rule and some kind of deficit control, i.e. debt dynamics control. Slovakian solution is along these lines, though the section of the deficit control is definitely too complicated.

Obviously there is a variety of legal solutions regarding fiscal constraints, primarily whether public deficit or sovereign debt is controlled as well as numerical fiscal rules stipulated by constitution or so sub-constitution legal act.

4. Numerical fiscal rules in Serbia: experience and lesson learned

In late 2010 the National Assembly of Serbia adopted the Amendments to the Budget System Law which introduced numerical fiscal rules and stipulates the establishment of Fiscal Council. Numerical rules were introduced for total public debt, deficit, as well as for total wage and pension expenditures, as follows:

a) Total public debt, not including future restitution claims, shall not exceed 45% of GDP.

Public debt, according to this Law, includes all the direct government debt and all issued general government guarantees, whether called or not. The Law stipulates that if the public debt ceiling is compromised, the Government has to submit to the Parliament (as part of the budget documentation) The Program on Debt Reduction.

b) Deficit rule is defined by a following formula:[6]

$$d_t = d_{t-1} - a(d_{t-1} - d^*) - b(g_t - g^*)$$

Where d_t and d_{t-1} are deficits (in percent of GDP) in years t ant t-1, d^* is a targeted long term deficit (defined in the Law at 1%), while g_t is real GDP growth rate in year t and g^* is a potential midterm growth rate. Parameters *a* and *b* influence the pace of adjustment and are defined in the Law for the 2011 – 2014 period (a = 0.3 and b = 0.4), while g^* is set at 4%.

The deficit rule is focused to the total, not structural deficit, hence ample room is created for the countercyclical fiscal policy. The problem is that the enforcement of the deficit rule is based on the projections on some variables (g_t is available only *ex post*) and speculation about the others (potential mid-term growth rate). Furthermore, legislators can change parameters *a* and *b* at their will and it this way substantially change the fiscal rule, i.e. change the level of deficit that is allowed.

So, at the time of adopting the Law, the formula looked as follows:

$$d_t = d_{t-1} - 0.3(d_{t-1} - 1\%) - 0.4(g_t - 4\%)$$

c) The Law also introduced indexation rules (effective “freezing”) for public sector wages and pension for 2011 – 2015 period, as a measure to control fiscal expenditures. It also stipulates that these rules shall also apply in post 2015 period, until share of pensions in GDP drops below 10% and share of wages in GDP drops below 8%.

The Law also specifies an important exception for capital expenditures, i.e. public investments – if the share of capital expenditures is above 4% of GDP (in 2011) or above 5% (in 2012 – 2015 period), the part above that threshold shall not be counted as deficit, but not more than 2% of GDP in total: further complication of the rule.

The Law was amended 9 times since 2010 (which is a vivid example of the time consistency problem, as most of the changes included wage and pension increases), but key rules, on debt and deficit, were not amended (as they did not, in fact, represent an obstacle anyway).

There are several flaws with the rules as defined:

a) Deficit rule is too complicated.

One of the main characteristics of a good rule is that it is clear and that it is easily observable whether the rule is violated or not. That is not the case with the Serbian deficit rule. It requires certain level of knowledge of mathematics even to understand what the formula means, let alone to actually calculate the allowed deficit. So, general public, media and politicians almost

[6] The deficit is question is consolidated public deficit that incudes general government budget, autonomous provinces budgets, local authorities’ budgets and the public funds (health insurance, pension insurance and social security).

completely ignored this rule in the public debate, as it is too complicated. All of the focus was on the debt rule, due to the fact that it is simple and straightforward.

b) Deficit rule is very difficult to implement as d_{t-1} and g_t are forecasts, not actual/historic numbers.

Budget is usually prepared in autumn. That means that at the point when the main aggregates for the next year need to be defined (such as total deficit), the actual numbers for current year are still unknown. That means that parameter d_{t-1} is unknown and instead of using actual numbers the government has to use projections, i.e. to forecast future values. That also means that the government has substantial latitude in this process.

If revenues and expenditures were more or less stable during the year this would not necessarily present a problem. But since spending of some items in the last two or three months of the year are especially large (most notably for capital investments, but also for some goods and services), estimating exact deficit even at the central level is not easy, let alone estimating deficits at other levels (such as local level). For example, in 2015 the deficit in December alone was higher than in previous 11 months combined (similar situation also occurred in 2014, so this is not extraordinary situation).

Similarly, g_t is also a projection. Since every 1 percentage point of deviation from the 4% long term growth rate allows additional 0.4% of GDP deficit, the Government has an incentive to project lower expected growth rate. On the other hand, this may balance the Government's incentive to project higher expected growth rate when forecasting revenues. Furthermore, as already pointed out, g^* is just a speculation, with the deficit prone Government has an incentive to specify higher potential growth rate.

c) Debt ceiling was lacking credibility as at the time of adoption of the Law (October 2010) debt was already above 40% of GDP.

It is rather unclear why 45% ceiling was adopted at the point when public debt was already very close to the ceiling. Basically, the only way that could justify such a decision was if the Government was certain in the success of the pending Telekom privatisation and was certain that a large share of privatization proceeds will be used for reducing the debt and/or financing of the deficit without new spending. But, that privatisation never occurred, so this rule was breeched within a year after adoption. If this explanation is true that is testimony of myopic government who enacted debt ceiling rule only taking into account near-term future.

d) Two rules could be contradictory.

The Law does not resolve potential contradictions between the rules. For example, if the debt is at 43% of GDP, but deficit formula allows 4% deficit, is the maximum allowed deficit 4% (as deficit rule says) or 2% (which would be consistent with debt rule)?

e) Deficit numbers are easily manipulated

Budget accounting in Serbia is still cash based with unclear rules and practice which items should be treated as revenues/expenditures ("above the line") and which items should be treated

as financing operations ("below the line"). That means that the government can easily hide the actual deficit by shifting spending below the line, or shifting some receipts as revenues above the line. For example, instead of giving a direct subsidy to a company (which would clearly be an expenditure), the government may either: a) take over some debt from the company and then repay the debt "below the line"; or even b) issue bonds and transfer them to the company (when they mature, the government "pays back the debt" below the line). These kinds of transactions became more frequent in the period after the fiscal rules were adopted and these transactions were recognized as expenditure only by the next government (which, therefore, not only did not suffer any political cost, but was actually able to shift additional blame to the previous government). Furthermore, many expenditures can easily be reclassified as capital expenditures and use the public investment by-pass provision for higher deficit to be allowed.

f) Debt rule does not clearly define when is the debt/GDP ratio calculated and what GDP should be taken into account.

Nominal GDP in Serbia is calculated and presented once per year, and it can take more than 12 months after the year is over for official numbers to be published. That means that current debt/GDP ratio always has to be based on some projection of GDP. That is probably a problem on its own, but a more serious problem is that the Law does not stipulate which projections to use. For example, if the debt/GDP ratio is calculated on a monthly level in August 2015, which nominal GDP (growth) projections should be taken into account: a) 2015 calendar year; or b) most recent four quarters (July 2014 – June 2015)?

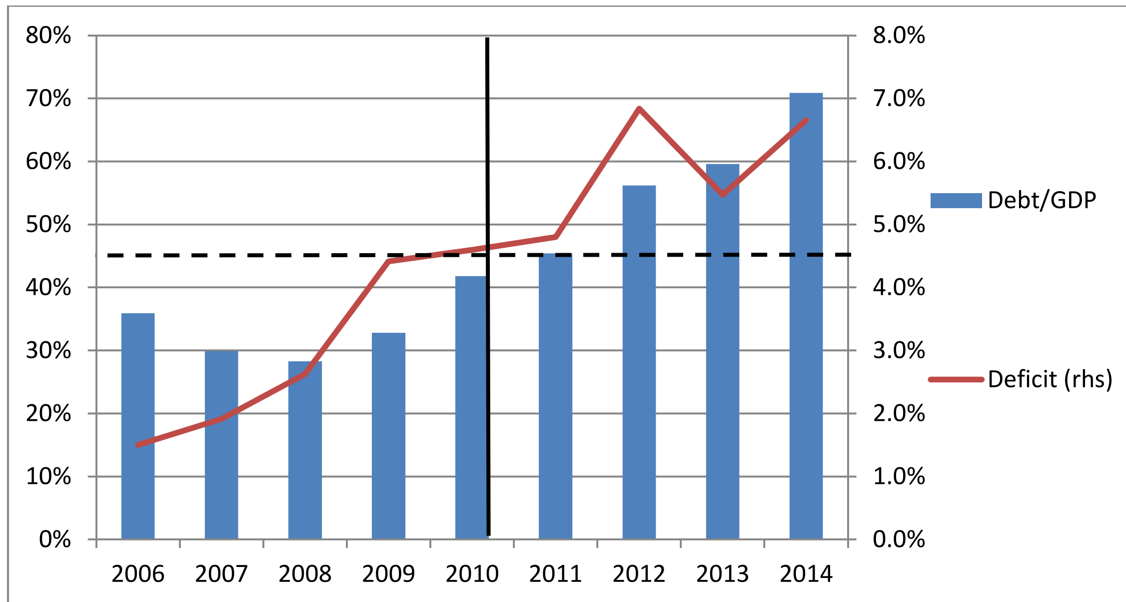
The Government has selected the easiest, the most convenient, but also the most deceptive mechanism, by using calendar year. For example, this means that without no new borrowing debt/GDP ratio falls from January 1st onward as the denominator becomes larger. This is the consequences of governments in principle projects positive economic growth, however it is sluggish. Nonetheless, with recession hits the country during the year, the debt/GDP ratio calculated in this way is higher than the actual debt ratio.

g) The most important flaw of the Serbian fiscal rules was that they were defined by a Law.

An ordinary law simply cannot limit the power of the National Assembly, as it can adopt any legislation which is in accordance with the Constitution. For example, although Budget System Law defined that the deficit cannot be higher than some formula-defined level (for example, 3% of GDP), the Parliament can still adopt the annual budget which envisages a deficit of 4% per year, and there is hardly anything that can been done about it. In that sense, any numerical fiscal rule defined by the Law simply cannot be effectively enforced and therefore represents only a wishful thinking, not a legally binding constraint.

Not surprisingly, the effects of the Serbian numerical fiscal rules were negligible, if any. The following graph shows the dynamics of total sovereign debt and public deficit (right scale), while the vertical line shows the time when the numerical fiscal rules were introduced – not just that deficit was not reduced, but has actually increased after the adoption of the law, resulting in continuous increase of the public debt.

Graph 1: Consolidated fiscal deficit and public debt in Serbia (as % of GDP)



5. Desirable features of numerical fiscal rules

Depending on the extent to which they constrain the government in the conduct of fiscal policy, there are hard and soft fiscal rules. Hard rules are those which are established by the Constitution or by law and establish clear limits, although they do not have to completely eliminate the possibility of discretionary fiscal policy (Ayusion-i-Casalas *et al.*, 2007). On the other hand, numerical rules could be soft rules, based just on political declarations and essentially non-binding agreement between political actors (for example, the coalition agreement, or expose of the new prime minister). These rules can also help to establish budget discipline, but they are usually considered to have less power.

There is also a sceptical view of the numerical fiscal rules. Von Hagen (2005) believes that numerical fiscal rules can be harmful if not followed by the right intention to bring public finances in order. On the other hand, if there is a real intention, then the fiscal rules are of secondary importance. Wyplosz (2002) suggests that very strict rules may impede the conduct of fiscal policy to such an extent that they become counterproductive. Von Hagen and Wolff (2004) have dealt with the issue of to what extent rules are implementable and effective, drawing attention to "creative" accounting that may effectively bypass the rules.

According to Kopits and Symansky (1998), the ideal fiscal rules should have the following characteristics: well-defined, transparent, simple, sufficiently flexible, in line with the ultimate goal, appropriate, and consistent and in accordance with the planned structural reforms. The authors believe that there are obvious trade-offs between these desirable characteristics, for example between flexibility and feasibility. The right balance should be found. Inman and Bohn (1996) in their review of the debt and the deficit in the American states suggested the following four characteristics of good fiscal rules: the appropriate moment to verify compliance with the

rule (beginning or end of the year), it should not be difficult to verify if the rule is violated by being circumvented, strong enforcement mechanism and that rule cannot easily be changed, but only in exceptional situations.

Political economy of fiscal rules should be taken into account because it is expected from politicians, who want to spend the other people's money on their constituency, to self-impose the rules. Even if they impose the rules during economic boom, there is nothing that prevents the rule changes again when recession hits. It also requires that voters are sufficiently aware and well-informed to subsequently punish fiscally irresponsible government. But, as demonstrated by Caplan (2007) this is rarely the case, because economic issues in general are often of secondary importance to voters, let alone the details of fiscal policy. Especially if the rules are too complicated to be understood by voters and if there is room for interpretation of what happened.

Generally, if the rules are well designed and implemented, they can remove the deficit bias, but the rules are largely disappointing in practice. One problem is with the time consistency of rules, because a situation can always arise in which the implementation of the rule is very expensive for the political leaders.

This means that the rule should be flexible enough to allow some discretion in exceptional circumstances, which means that it is important to define exceptions very precisely. Also, there is a trade-off between flexibility on one hand and whether the rule is simple and understandable to ordinary citizens on the other hand. For example, completely banning deficits is very clear and precise, but not only it limits discretion, it also directly imposes pro-cyclical fiscal policy. On the other hand, if requirements for a balanced budget over the business cycle is introduced, the rule suddenly becomes not only incomprehensible to ordinary citizens, but also *de facto* unenforceable because the correcting the deficit by the stage of the business cycle is very controversial area of macroeconomics and allows great latitude in decision-making.

Rules can be manipulated in other ways. For example, the government can always achieve balanced budget *ex ante* by making unrealistic revenue projections. Of course, it is possible to analyse *ex post* compliance with the rules, but then it is usually too late to do something from the legal standpoint.

A good balance between the rule being effective and being complicated/understandable is one of the key conditions for the rule be successful. On the one hand, the rule should make economic sense, as to have beneficial impact to national economy, in order to have the support of voters and their elected representatives – politicians. But, on the other hand, the rule should be clear and simple and it should be easy to monitor its implementation and to reduce the scope for discretion and manipulation. The optimal balance between the two features probably depends primarily on the institutional environment in which the rules are enforced, i.e. administrative capacity of the country, as well as the level of the local political awareness.

It is inevitable that as rules become more complex, they *ceteris paribus* become less and less clear and transparent, which means that monitoring the implementation becomes more difficult, and therefore undermines the incentives to decision makers to follow those rules. Complex rules also leave plenty of room for disagreement and discussion, which creates the opportunity for politicians to make discretionary decisions.

Essentially there are two concepts of rules regarding their enforcement. One is "hard" rules that are legal rules, and hence ultimately applied by the court, and the other kind are "soft" rules, which essentially boils down to monitoring and enforcement by the public (constituency and/or taxpayers), politicians (both those in power and those in opposition), but also by the financial markets which may, though not necessarily "punish" fiscally irresponsible government by increasing the costs of borrowing. In that sense, although Serbian fiscal rules are defined in the Law, they are effectively soft rules as their enforcement does not rely on courts.

Of course, there is a link between the strength of the rules ("hard" or "soft") and the extent how well they are developed. If the rule is soft, then it should be rather simple and not well developed, since we expect “penalty” for its violation is from not highly sophisticated voters and other politicians. If the rule is "hard", it is necessary that all details are prescribed, and it must be well developed, but then such a rule can lack transparency. For example, if the Constitution stipulates that the structural deficit cannot be higher than 3% of GDP, it is necessary to have a very detailed regulations about what is the meaning of the term "structural deficit", how it is calculated, i.e. how structural deficit is separated from the total, how GDP is calculated etc., so that the court can make a decision.

Regarding soft rules, it is obvious that the rule should not be "deficit must not be higher than 3% of GDP during the economic cycle" because for the general public is not clear what "over the economic cycle" means. In such a situation, the government can always claim that the economy is right now in a recession and that therefore additional fiscal stimulus is required, hence the higher deficit is needed. Since the issue of identification of stage of the business cycle is very controversial, even in the academic terms, let alone in the political arena, this rule is inappropriate and non-transparent.

There was a relatively simple rule in the European Union that the deficit must not be higher than 3% (one of the Maastricht criteria). However, many (both economists and politicians) have argued that such a rule was too rigid and that simply did not leave enough room for countercyclical fiscal policy in conditions in prolonged recession. That is one of reasons for moving from monitoring a simple deficit to "structurally adjusted deficit" that takes into account the stage of the business cycle. The goal is to solve the problem of rigidity, but at the expense of transparency, because it is undoubtedly very difficult to determine at what stage of the business cycle the economy is. During 2003, the European Commission has changed the methodology of calculating the deficit, but only after numerous conflicts and much confusion.

In this sense, perhaps "optimal level of complexity” should be considered, as the level that represents the optimal trade-off between complexity and transparency of rules, and that optimal level probably differs from country to country, depending on the institutional environment in which it is implemented. More complex rules are likely more favourable for countries where the institutional development level is higher, while the simpler rules are probably more suitable for institutionally less developed countries, with small administrative capacity. For example, if there is a widespread suspicion in an institution that collects economic statistics, a complex rule, which takes into account the phase of the business cycle will simply not be credible.

So, if the rules are difficult to implement due to low administrative capacity, then it is necessary that they are simple. On the other hand, when the administrative capacity allows for the implementation of the rules, then they can, but not necessarily should, be more complex.

6. Proposal for Serbia

The recommendation that follows is based on a few observations on Serbia:

(1) Law based numerical fiscal rules are not likely to be effective in Serbia as the National Assembly is not constrained to adopt new legislation that will undermine the rules and even amend the legislation that provides these rules. This is especially true because of the fact that political parties dominate the parliament, not MPs, which is inevitable consequence of the proportional representation in its pure form (one constituency and closed list) as is specified by the Constitution and election legislation.

(2) Lack of well developed, efficient and independent civil service in Serbia, rendering the lack of administrative capacity needed for swift, efficient and impartial enforcement of the fiscal rules. Perhaps the most warring is the national statistical office well needed for enforcement of complicated fiscal rules. The Ministry of Finance administrative capacity is also low and unfortunately decreasing. Though the Fiscal Council contribution to sound public finances in Serbia is significant, that authority is still institutionally young and fragile.

(3) Preferences of the Serbian constituency towards simple issues of political life over rather complicated, difficult to follow issues and those which are not perceived as something that directly influence welfare of the voter. Serbian median voter has rather limited capacity to absorb abundance of specific information dealing with the fiscal process its outcomes and the implication for long-term economic progress of the country and improved welfare of the voter himself/herself.

According to the observation (1) Serbia should introduce constitutional constraints, i.e. numerical fiscal rules should be introduced to the Constitutions. Only technical details of enforcement of the fiscal rules should be stipulated by law.

According to the observations (2) and (3), the proposed rules must be simple, understandable and straightforward, with minimum of the latitude in their implementation. That limits the options for the main target of the fiscal control. One option is (consolidated) structural fiscal deficit, as total deficit is maybe not good target, due to the "straightjacket" it creates in the time of recession with limited opportunity for countercyclical fiscal policy. It has been demonstrated in the section four of the paper that Germany, Slovenia and Spain only target structural deficit as the fiscal rule.

Targeting structural fiscal deficit creates two methodological issues:

- Identifying the stage in the business cycle;
- Identifying one-off factors on both revenue and expenditure sides

Of course, all countries that apply targeting structural deficits face these problems, but there is a lack of administrative capacity of Serbian authorities in charge of fiscal policy making (primarily Ministry of Finance) and in charge of monitoring macroeconomic developments. Furthermore, these authorities are not independent from both executive and legislative government, creating a risk of their influence to the decisions about stage of the business cycle, for example, with substantial impact of the deficit that is within the numerical rules. The Constitutional court that will be in charge on enforcing these rules will inevitably base its decision on the calculations delivered by these authorities, and that would inevitable undermine the independence of the Constitutional Court.

The importance of the accurate identification of the structural deficit in Serbia is that the country can still expect relatively significant privatisation proceed, either from selling of state owned equity or assets. The privatisation proceeds are not considered to be fiscal revenue and are therefore only used for financing of the public deficit. This would imply that privatisation proceeds cannot be used for any additional budgetary expenditures. Nonetheless, the rule of the thumb would be that privatisation proceeds should not be used for expanding any of the recurring expenditures, i.e. entitlements (pensions, public sector wages, social programs, etc.), but they should be used exclusively or one-off expenditures, like public investments.

The alternative to the deficit rule is sovereign debt rule as a numerical fiscal rule, applied by Poland and Slovakia. This rule is very simple and straightforward as the debt-to-GDP ratio is a well-defined indicators, used by most countries for macroeconomic purposes and common in in debt sustainability analysis. Accordingly the level of the country sovereign debt measured as debt-to-GDP ratio should be the primary numerical fiscal rule.

The enforcement of such a numerical fiscal rule leaves some open methodological issues, most of them based on the classification of the sovereign debt, i.e. whether some obligation should be classified as sovereign debt. First of all, it is the status of sovereign guarantees. Current Serbian Public Debt Law treats all issued guarantees as public debt, even in cases when the borrower (usually a state owned enterprise) is perfectly capable of servicing the debt. In some other jurisdictions, only called guarantees are included in the debt. It should be recommended that Serbia should continue with a more conservative approach – all issued guarantees should be considered as public debt.

Furthermore, the deposit insurance creates obligations to the budget and these obligations must be serviced from the budget in the case of bank failure. Common contemporary practice is not to include insured deposits in the sovereign debt, though that insurance creates fiscal risk. The main difference between sovereign guarantees (that should be included in the debt) and deposits that are insured is that deposit insurance premium is paid to the Deposit Insurance Agency that is obliged to pay the insured amount of deposit to the depositor if the bank fails. Only if the insurance fund of the Agency is not enough for all insured deposits to be paid out, the government steps in and supplements the amount that should be paid to depositors. Although there is some fiscal risk in deposit insurance, the insured deposits should not be included in the sovereign debt. This attitude is already confirmed in the Public Debt Law and that law should not be amended regarding the status of insured deposits. However, once fiscal risk materializes (a bank fails) payments and liabilities arising from deposit insurance will “eat” part of the deficit and/or debt space.

Another methodological dilemma is the treatment of the PPPs. It can be expected that strict numerical fiscal rules will provide more incentives for the Government to enter the PPPs as a way to avoid direct debt increase. In that case the crucial question is the treatment of the risk, i.e. risk distribution between the public and the private partner. For example if there is a toll highway concession contract with the provision that the Government guarantees minimum traffic of 12,000 AAVPD, if the traffic is below the threshold, the Government is obliged to pay the difference of the toll, i.e. government debt is created. As in the case of deposit insurance, this kind of fiscal risk cannot be dealt with classifying it as a sovereign debt, if not for some other reason than for the reason that the figure of the debt is not available *ex ante*. Nonetheless, if the debt ceiling has already been reached, that these PPP contract (international or domestic) should not been ratified in the National Parliament, as they should be considered as violation of the fiscal rule. In they are ratified by a law, that law should be considered violation of the Constitution.

The fiscal rule that is consisted only of the permitted level (ceiling) of the sovereign debt to GDP ratio creates one huge fiscal risk and that is the risk of ample borrowing of fiscally irresponsible government when the level of the sovereign debt to GDP ratio is low. Accordingly the pace of the borrowing of fiscal irresponsible government should be checked and balanced. The best way to do than is to constrain annual "net new borrowing" of the government, i.e. annual "incremental debt" - the increase of the debt during the year. If net new borrowing is negative, the level of debt will decrease. Net new borrowing is not necessarily equal to the fiscal deficit, as there are one-off revenues (receipts) that are not classified as budgetary revenues like, for example, privatisation proceeds either from sale of capital or assents. With privatisation proceeds net new borrowing is lower than the total deficit.[7]

The new net borrowing limit should be specified in relation to the level of the debt to GDP ceiling and the proximity of the debt to that ceiling. If, for example, the debt to GDP ceiling is 80% than it is recommended to apply the following net new borrowing ceiling scheme.

Table 2. Ceiling of the annual net new borrowing

Level of sovereign debt (% GDP)	Ceiling of the annual net new borrowing (% GDP)
Below 40%	No ceiling
40-50%	8%
50-60%	6%
60-70%	4%

[7] As a rule of the thumb of sound fiscal policy, privatisation proceeds as one-off proceeds should not be used to finance deficit in the area of recurrent payment, i.e. entitlements. These proceeds should be used for one-off outlays, like capital expenditure or (premature) pay-off of the debt.

70-80%	2%
Over 80% (ceiling violated)	No new net borrowing

This pattern of the changing of the ceiling for the annual net new borrowing produces the following outcome: if the Government indulges in the maximum amount of annual net borrowing every year, it takes five years to reach the ceiling of the debt-to-GDP ratio. That period is longer that the constitutional mandate of government.

Finally, the ceiling of the debt-to-GDP rule should have priority over annual net new borrowing rule for any ambiguity to be removed. That means that if the level of debt-to-GDP ratio is 79%, ceiling for the net new borrowing in that year is 1% of the GDP. The same effect can be made if both rules are cumulative condition for new net borrowing.

The issue of the specification of the concrete value of the ceiling for the level of debt-to-GDP ratio is beyond the scope of this. The 80% ceiling has been used only as an example for calculation of the decreasing ceiling for the annual new net borrowing. This issue is linked to the issue of debt sustainability and that issue is rather complex and not straightforward (IMF, 2013), as many factors should be taken into account. The best way forward would be that the Fiscal Council, as a part of the preparation of the proposal for changes the constitution specifies the ceiling of the debt-to-GDP ratio for Serbia.

The mechanism of the implementation is based on the Constitutional Court review of every piece of legislation that violates the recommended numerical fiscal rules. Fiscal Council could prepare the basic analysis providing information for the Constitutional Court review.

There is a possibility that ceiling of the debt-to-GDP ratio is violated for u number of reasons, which are not under direct Government controls, like:

- Change of the exchange rate of RSD as well as exchange rate among the currencies that the Serbian debt is consisted of.[8]
- Decrease of the GDP due to the recession.
- Decrease of the GDP due to its recalculation.[9]
- Increase of the debt due to the activation of some governments obligation like deposit insurance, risk allocation in PPPs etc.

[8] Only a small share of Serbian debt is actually issued in local currency. That means that the country is substantially exposed to the exchange rate risk. The changes can go both ways: they can increase as well as decrease level of the debt-to-GDP ratio without any new borrowing or repayment of the debt.

[9] The data on the GDP level are available only *ex post*. The ceiling is based on the estimate of the GDP, so changes are possible. Apart from that, recalculation of the GDP in Serbia is quite common in a last few years due to many factors that are beyond the scope of this paper. These recalculation can be expected in years to come.

In all these cases, if the ceiling of the level of debt-to-GDP ratio is violated, any new net borrowing will violate the fiscal rules. But, as the cause for debt increase was not a direct Government and/or Parliament action, there is not action to be ruled unconstitutional,.

This structure of fiscal rules provide solid foundation for fiscal discipline. Nonetheless, it is evident that if the level of debt-to-GDP ratio is very close to the ceiling, the room for fiscal deficit as the ground for countercyclical fiscal policy is very limited. That insight should be considered within the following framework. First, this creates strong incentives for governments not to run huge fiscal deficits during the boom times and to leave the room for the deficit as demand management tool. Second, as there is still substantial value of state-owned capital and property, selling of that property in the time of recession can create fiscal expansion as the countercyclical policy. Finally, countercyclical fiscal policy in Serbia should not be overvalued and its impact should not be overestimated. It has been demonstrated (Petrović and Brčerević, 2014) that fiscal multiplier in Serbia is low, its impact rather negligible and the demand side for the growth should be net export (Petrović, 2011) rather than aggressive fiscal stance. Accordingly, the proposed solution provides for sufficient countercyclical fiscal policy in recession.

7. Conclusion

Recommendations for numerical fiscal rules in Serbia are based on the insights about inherent bias of fiscal policy towards expenditures and, because of that, continuous fiscal deficit and excessive sovereign debt. Hard numerical rules are superior to the soft for Serbia, because of the long tradition of substantial latitude of the Serbian legislators in the decision making process, especially budgeting. The rules should be simple and understandable, without much of the latitude in the implementation. Accordingly it is recommended that simple and straightforward numeric fiscal rules should be in introduced in the Constitution, i.e. that constitutional fiscal rules should be introduced in Serbia. There should be two cumulative numerical fiscal rule. The primary one about the ceiling of the sovereign debt and the secondary one about the ceiling on net new borrowing. Neither of the rules can be violated. The ceiling on the debt level should be predetermined by the Constitution. The ceiling on the new net borrowing should depend on the distance of the sovereign debt to the debt ceiling. An illustrative example with the debt ceiling of 80% is provided. Nonetheless, a specific sovereign debt ceiling as a part of constitutional amendments proposal should be specified by the Fiscal Council, taking into account projections of the fiscal deficit and debt sustainability analysis. Accordingly, this contribution remains silent on the specific constitutional debt ceiling for Serbia.

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