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A CASE FOR THE INTRODUCTION OF NUMERICAL FISCAL RULES IN THE SERBIAN CONSTITUTION¹

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ABSTRACT: *The recommendation of numerical fiscal rules in Serbia, presented in this paper, is based on the inherent bias of fiscal policy towards expenditure, and consequently continuous fiscal deficit and excessive sovereign debt. It is recommended that simple and straightforward numeric fiscal rules should be introduced into the Serbian Constitution. There should be two cumulative numerical fiscal rules, the first regarding the ceiling on sovereign debt and the second regarding the ceiling on net new borrowing. Neither of the rules may be vio-*

lated. The ceiling on the debt level should be prescribed by the Constitution. The ceiling on new net borrowing should depend on the distance of the sovereign debt from the debt ceiling. An illustrative example is provided, with a debt ceiling of 60%. However, the Fiscal Council should specify a specific sovereign debt ceiling as part of the proposed constitutional amendment.

KEY WORDS: *numerical fiscal rules, constitution, public debt, fiscal deficit, economic growth, Constitutional Court, Fiscal Council*

JEL CLASSIFICATION: H62, H63

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1. INTRODUCTION

In the aftermath of the global financial crisis the sustainability of public finances and especially sovereign debt has become one of the most important topics in Europe. Diverging fiscal circumstances across European countries reflect their different political institutions, history, and culture, but to some extent are also the result of their economic performance and fiscal institutions.

In the past 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 achieved this by 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 has introduced so-called ‘debt break’ provisions in its constitution.

Serbia also introduced fiscal rules in 2010 through amendments to the Budget System Act by limiting the public debt-to-GDP ratio to 45% (excluding future restitution claims) and by introducing a permitted deficit formula. However, neither of these rules was implemented after their adoption: the debt rule was broken within a year of its introduction and the deficit rule was mostly ignored. It seems that the main reason for the ineffectiveness of the fiscal rules is the fact that laws cannot limit the power of the National Assembly to adopt another law. For example, the National Assembly can adopt whatever annual Budget Law it wants. Thus, there are strong arguments for the claim that only constitutional constraints may be effective in this case.

Nonetheless, the Serbian Constitution is almost completely silent on fiscal issues. It only stipulates that all revenues and expenditures have to be presented in the budget and that the 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 constraining public spending policy. The aim of this paper is to test this hypothesis and to explore the nature of these constraints; i.e., to propose the content of the amendments.

Accordingly, the first section of the paper offers a literature overview regarding reasons for constraining the government’s (executive and legislative) discretion in issues of fiscal policy. The next section explores experiences regarding legal constraints to fiscal policy in several relevant countries. In the following section

the current legal framework for fiscal responsibility in Serbia is analysed, along with its shortcomings. Finally, a proposal for Serbian constitutional amendments is presented and discussed.

2. LITERATURE OVERVIEW

The literature has identified a number of reasons for introducing rules, i.e., constraints, in fiscal policymaking, and not simply letting democratically elected parliaments freely adopt any fiscal policy.¹ Most of these reasons are related to either irrational or rational biases in policymaking, whether on the part of policymakers or on the behalf of voters ('deficit bias'). Schuknecht (2004) identifies 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 between interest groups, and 4) common pool problems (tragedy of the commons).²

2.1 Fiscal illusion

Fiscal illusion is when voters are not fully aware of the tax costs of a given public policy. When voters have a clear benefit from some public policy but the costs are hidden or invisible they demand increased public expenditure from politicians. According to Dollery and Worthington (1996), there are several different causes of fiscal illusion.

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

1 The rationale for such constraints is that excessive public debt produces negative effects in economic growth. This is accepted as a basic assumption of this paper, i.e., a rationale for the constitutional constraint of fiscal policy. Recent research on this issue (Kumar and Woo 2010; Cecchetti, Mohanty, and Zampolli 2011; Reinhart, Reinhart, and Rogoff 2012) provides overwhelming evidence of the negative effect of public debt above 85%-90% of GDP on economic growth, reducing it by 1%. Nonetheless, there are other thoughts about these results regarding the causality in the case of OECD countries (Panizza and Presbitero 2014) and the exact threshold level for growth deceleration (Egert 2015).

2 Eslava (2011) has provided a comprehensive survey of political economy research on fiscal deficit

Related to this is the phenomenon of ‘renter illusion’ (Blom-Hansen 2005). Taking into account that in the US most local fiscal revenue comes from property taxes (paid by property owners), the ‘renter illusion’ hypothesis is that in municipalities where the share of renters (lessees) is high, public expenditure will also be high, as renters do not realize that they are the ones actually paying the property taxes through higher rents. This can, of course, be generalized to include other, similar cases (for example, consumers supporting higher corporate profit tax without understanding that a likely result will be an increase in prices).

Furthermore, fiscal illusion is more pronounced at the levels of government that rely most heavily on transfers from other levels of government and where public expenditure is 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 financed by transfers from higher levels of government or even a foreign government, 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 the fiscal illusion will be greater, as voters are not fully aware of the resulting future tax increases, and even if they are, their intertemporal preferences could be strongly in favour of current consumption.

2.2 Election cycles

Election cycles can also be a source of deficit bias and fiscal policy instability, as there is a clear incentive for incumbent politicians to implement expansive fiscal policy prior to elections. Many different economic models have been developed to analyse the links between political and business cycles. Nordhaus (1975) starts from the premise that democratically elected politicians heavily discount public consumption after elections. In turn, while private investors prefer to sacrifice short-term consumption for long-term investment and consumption, public investors (i.e., elected politicians) do not usually behave in the same way. Therefore, it is to be expected that the period before an election will be a period of expansive fiscal policy, and it can only be hoped that after the election it will be more restrictive.³

³ It has been demonstrated (Ebeke and Olcer 2013) that this mechanism works even in low-income countries, many of which are flawed democracies.

Furthermore, business cycles and political cycles are not synchronised, creating incentives for procyclical fiscal policies. Hence, numerical fiscal rules could also reduce policy procyclicality. Bergman and Hutchison (2015) empirically demonstrate that effective numerical fiscal rules have substantial countercyclical effects through reducing fiscal policy procyclicality. The crucial prerequisite for these results is that government efficiently enforces these rules. A minimum of enforcement efficiency is identified, which threshold must be reached in order for the rules to be effective.

Deficit bias should also be considered in the framework of time inconsistency. This is the phenomenon where, 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 is reducing inflation in democratic governments. Politicians promise lower inflation in the future, but once the future comes reduction is further delayed due to the short-term risk of higher unemployment. This was one of the reasons for the introduction of independent central banks, based on the belief that central banks that are not under political pressure to increase growth and employment in the short-term will more easily and credibly enforce a low-inflation policy. It is evident that a similar phenomenon exists in the case of fiscal policy, where 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.

2.3 Asymmetry of allocation of costs and benefits

Another source of deficit bias is asymmetry in the allocation of costs and benefits. The single taxpayer does not receive benefits from government expenditure that correspond to his/her tax burden. Interest groups work to increase benefits from spending for their members and use various advocacy mechanisms and lobbying to influence public policy, leading to pork barrel spending, i.e., targeted specific transfers.⁴ The primary goal of interest groups is to make the government implement policies that directly benefit their members, while the cost is spread

⁴ Battaglini and Coate (2008) formulated a formal dynamic equilibrium model based on the assumption that there are two types of public spending: 1) provision of public good and 2) targeted transfers. Exogenous shocks in the value of the public good create policymaking cycles through legislators' adjustments to these shocks. Using this model as the framework for their analysis, Azzimonti *et al.* (2016) demonstrate that fiscal deficit rules that preclude deficit lead to gradual reduction of the public debt if demand for the public good is relatively low. Nonetheless, the welfare effects of such a rule in the model depend on preferences concerning tax volatility and the public good provided.

over millions of uninformed and unorganised taxpayers/voters.⁵ Such separation between costs and benefits can easily lead to overspending. Bearing in mind that budgetary decisions are made by politicians whose primary goal is to be re-elected, political support from well-organised small groups can be more important than support from unorganized and uninformed constituents. Therefore, politicians face incentives to redistribute resources towards well-organized groups, increasing public expenditure, as demonstrated by Olson (1965).

2.4 The common pool problem

It has also been demonstrated that the budget process suffers from the common pool problem (Alesina and Perotti 1996; Von Hagen 2008). From the point of view of the executive power (mainly cabinet ministers) the budget is a common pool. Although there is rivalry in consumption (the money spent on one ministry cannot be spent on another), costs are distributed between all the ministries, i.e., the entire executive government. The same goes for the legislative branch of power, as the representatives are incentivised to increase/maximise public expenditure in their own constituencies, without taking into consideration the effect of this expenditure on the budget as a whole. Furthermore, it is not possible to exclude those who have an agenda that includes huge public expenditure; the common pool problem only encourages a political agreement among those with an incentive to spend more. Hence, the main problem is that all public expenditure is financed from a common pool (budget), while decision-makers have every incentive to increase expenditure in their own constituencies, thus increasing overall public consumption.⁶

5 Single-issue political parties, like pensioners' parties, can be considered as interest groups organised as political parties, as they are only interested in increasing specific public expenditure benefits for the members of that interest group, i.e., supporters of and voters for that political party. The political party framework enables them to overcome the free rider problem effectively, so these parties can represent large interest groups.

6 The common pool problem does not exist among legislators in the case of pure proportional representation, i.e., where there is only one constituency and a closed list of candidates. It arises with the advent of single-issue parties with well-defined constituencies that are not territorial (i.e., enhanced interest groups), like pensioners' parties in the transition economies. However, the common pool problem remains in the executive branch and is augmented in a coalition government with ministers from several political parties. There are strong incentives for ministers to increase public expenditure in their ministries in order to boost the political rating of their own political parties, and so the common pool problem is aggravated.

2.5 Academic consensus achieved?

This literature overview shows that there is an academic consensus that deficit bias is a real-world phenomenon, limits should be imposed on decision-makers in order to reduce the space for unconstrained decision-making, and an incentive mechanism should be in place to penalize irresponsible behaviour and promote responsibility. For example, more transparent public finances allow voters to obtain data on which to base their voting decisions.

Constraints can take forms other than transparency. Numerical fiscal rules set limits to and targets for certain fiscal aggregates (deficit, debt, expenditure, revenue, etc.). The introduction of formal rules is one way to force political decision-makers to look at the broad picture, i.e., to take into account the common pool issue. It is essential that these rules are procedural and permanent, or at least enduring, i.e., very difficult to change. Rules can only help solve the issue 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. This is why it is reasonable to make changing the rules difficult, for example, by constitutionalising them.

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

The reviewed literature demonstrates that there is academic consensus on the need for persistent fiscal rules, i.e., rules that will decrease the risk of continuous fiscal deficit and excessive sovereign debt. This consensus existed even before the global financial crisis of 2008; the crisis merely amplified the need for constraining fiscal deficit and sovereign debt, and is one of the factors that influenced the advent of formal legal numerical fiscal rules in EU countries.⁷

⁷ The ultimate justification for these rules is the empirical result that the growth rates of the member states were higher during periods when the EU fiscal rules were followed (Castro 2011).

3. CONSTITUTIONAL RESPONSES TO FISCAL DEFICIT AND PUBLIC DEBT IN THE EU

3.1 Supranational level

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

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

As a way of operationalising these targets, the Stability and Growth Pact (SGP) was signed in 1997, with the main goal of providing incentives for complying with the rules and disciplining member states. Some of the measures and mechanisms were the prohibition of deficit financing by the European Central Bank (ECB) or the central banks of member states (Article 123), an explicit provision that neither the European Union nor any member state should in any way be liable for the debts of other member states (Article 125), and prescribing a procedure for excessive deficit (Article 126). The SGP also introduced procedures to coordinate and oversee national economic policy (Article 121).

However, in 2003 these rules were abandoned *de facto* when the European Council failed to impose the excessive deficit procedure against the two largest member states (Germany and France) amid apparent violations, despite the European Commission having started the procedure.

The debate on reforming the SGP began in 2004, and a new SGP was adopted in 2005 with the main objective of making the rules more flexible. This was achieved primarily in three ways: 1) medium-term objectives should differ between countries depending on circumstances; 2) deficit objectives should be structural (taking into account the stage of the business cycle and not one-off factors), and 3) the level of public debt must be taken into account. The ECB criticized this agreement because it doubted its power to force member states to conduct responsible fiscal policy. However, in the boom of that time (just like when the initial SGP was implemented) its shortcomings were barely visible.

With the advent of the 2008 global financial crisis the weaknesses of the revised plan were revealed. Member states reacted differently to the recession: some began implementing major fiscal stimulus programmes, while others (such as Germany) implemented more conservative policies.

In 2011 the SGP was changed again (accompanied by the adoption of a so-called ‘six-pack’ of EU regulations), with the basic idea of alleviating the perceived problem and preventing further accumulation of public debt, which was the main cause of the eurozone crisis. These new rules introduced additional criteria for reducing public expenditure if debt levels exceeded 60% of GDP. Also, the European Commission’s proposal for implementing the Pact could only be refused by a qualified majority in the Council, which was seen as a significant strengthening of sanctions (formerly the European Council had to actively vote for sanctions). Finally, in 2013 two additional regulations (‘two-pack’) were introduced. According to these rules, eurozone members must submit draft budgets to the European Commission before they are adopted by Parliament, and the Commission has the right to request changes if it considers that budgets violate SGP rules or that there is a high risk of that outcome.

However, most important for the debate on constitutional fiscal rules is that by signing the Fiscal Compact,⁸ eurozone members have committed themselves to adopting binding rules (preferably by amending their constitutions) which commit them to a balanced budget, including an automatic corrective mechanism if the fiscal deficit is too high.

Article 3 of the Fiscal Compact makes the following prescriptions.

- 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 for temporary deviation from the medium-term objective but “only in exceptional circumstances”, defined in Paragraph 3 as an “unusual event outside the control of the Contracting Party concerned which has a major impact on the financial position of the general

⁸ The Fiscal Compact is an international agreement signed by all EU member states except the Czech Republic and the United Kingdom, effective from the beginning of 2013, whose purpose is the strengthening of the economic and fiscal coordination mechanism and control of the signatory member states.

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 Fiscal Compact mandates that all signatories must introduce binding rules with the goal of having a budgetary deficit of 0.5% of GDP at most in the medium-term.

The resulting EU framework is very complex and lacks transparency. In late 2015 the Network of EU Independent Fiscal Institutions published a position paper, calling for simplicity, improved transparency, and clearer implementation rules.⁹

3.2 EU member states – content of the constitutional numerical fiscal rules

The content of the numerical fiscal rules varies from one European constitution to another. Nonetheless, some patterns can be established. Apart from general proclamations of the numerical fiscal rules, constitutions stipulate specific numerical fiscal constraints in support of them, considerations to be taken into account while balancing revenues and expenditures and/or maintaining some specific level of public debt, and the sanctions in case of violations.

Constitutions enshrine the numerical fiscal rule, in general and succinct terms, by stating that public administrations “shall adapt their actions to the principle

⁹ The evaluation concludes that streamlining fiscal rules is necessary because the current system has become too complex, hindering transparency and communication and ultimately putting at risk its effectiveness and credibility. The most recent reforms of the EU fiscal governance framework have resulted in perhaps too high a number of EU-level and national fiscal rules. Consistency of the rules is not fully guaranteed, and they are becoming increasingly sophisticated and are sometimes based on methodologies that are too complex (difficult to understand for the general public) or even require interpretation agreements or decision trees for policymakers. Changes in these methodologies and secondary legislation are too frequent (not always well understood or casting doubt on the true reason for the amendments). The transparency of these methodologies and procedural understandings is limited. For more see http://www.rozpocetovarada.sk/download/position_paper_final.pdf.

of budgetary stability”¹⁰ and that “revenues and expenditures shall in principle be balanced”,¹¹ or, in a more elaborate formulation: “Revenues and expenditures of the budgets of the state must be balanced in the medium-term without borrowing, or revenues must exceed expenditures”.¹²

Furthermore, and more importantly, the constitutions introduce specific numerical fiscal constraints on government expenditure. Accordingly, they stipulate that the principle of balanced revenues and expenditures “shall be satisfied when revenue obtained by the borrowing of funds does not exceed 0.35 percent in relation to the nominal gross domestic product”,¹³ or that “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”.¹⁴

The Spanish Constitution refers to relevant supranational rules. “Neither the State nor the Autonomous Communities shall enter into a structural deficit beyond the limits stipulated, if applicable, by the European Union for its Member States” (Art. 135[2]); “the volume of public debt for all the Public Administrations as a whole as a ratio of the State’s Gross Domestic Product shall not surpass the benchmark figure set forth in the Treaty on the Functioning of the European Union” (Art. 135[3]). It is left to an organic law to “set the structural deficit ceiling allowed for the State and for the Autonomous Communities according to their Gross Domestic Product” (Art. 135[2]). It adds that “loans to cover the interest and capital of the Administrations’ public debt shall always be understood to be included in the expenditure statement of their budgets”, and that a “repayment of the same shall be awarded utmost priority”.¹⁵

Nonetheless, constitutions also allow for the consideration of “the adverse and favourable phases of the business cycle” when balancing revenues and expenditures in the budget.¹⁶ In other words, “when economic developments

¹⁰ The Constitution of Spain, Art. 135(1)

¹¹ The Constitution of Germany, Art. 115(2). For a similar provision, see The Constitution of Italy, Art. 81(1)

¹² The Constitution of Slovenia, Art. 148(2)

¹³ The Constitution of Germany, Art. 115(2)

¹⁴ The Constitution of Poland, Art. 116(5)

¹⁵ The Constitution of Spain, Art. 135(3)

¹⁶ The Constitution of Italy, Art. 81(1)

deviate from normal conditions, effects on the budget in periods of upswing and downswing must be taken into account symmetrically”.¹⁷

More precisely, constitutions provide for the overrunning of “ceilings on structural deficit and public debt volume [...] in the event of natural catastrophes, economic recession or situations of extraordinary emergency which are beyond the State’s control and considerably harm the State’s financial situation or its economic or social sustainability”.¹⁸ Also, “in cases of natural catastrophes or unusual emergency situations beyond governmental control and substantially harmful to the state’s financial capacity” the yearly limit on net borrowing “may be exceeded”, but that “decision has to be combined with an amortisation plan”, and repayment of these credits “must be accomplished within an appropriate period of time”.¹⁹ However, some constitutions are not so explicit regarding the conditions under which the derogations are possible: “Temporary deviation from the principle of balanced revenues and expenditures is only allowed when exceptional circumstances affect the state”.²⁰

The constitutions of Spain (Art. 135[4]) and Germany (Art. 115[2]) require an absolute majority in the Congress of Deputies and Bundestag, respectively, in order to take measures that derogate from their usual obligations, while the Italian Constitution requires “authorisation by the two Houses approved by an absolute majority vote of their Members”, and the Slovenian Constitution stipulates that such derogation “shall be determined by a law adopted by the National Assembly by a two-thirds majority vote of all deputies” (Art. 148 [3]).

Further guaranties of the numerical fiscal rules include the constitutionalisation of legislative reservations concerning “the method for calculating the value of the annual gross domestic product and national public debt”²¹ and the public administration’s authorization “to issue public debt or to enter into borrowing commitments”.²² In other words, these matters have to be specified exclusively by law. The German Constitution is particularly exhaustive in this respect: “The regulation of details, especially the adjustment of revenue and expenditures with regard to financial transactions and the procedure for the calculation of the yearly limit on net borrowing, taking into account the business cycle on the basis

¹⁷ The Constitution of Germany, Art. 115(2)

¹⁸ The Constitution of Spain, Art. 135(4)

¹⁹ The Constitution of Germany, Art. 115(2)

²⁰ The Constitution of Slovenia, Art. 148(2). See also The Constitution of Italy, Art. 81(2)

²¹ The Constitution of Poland, Art. 116(5)

²² The Constitution of Spain, Art. 135(3)

of a procedure for adjusting the cycle together with the control and balancing of deviations of actual borrowing from the credit limit, requires a federal law” (Art. 115[2]).

There is also a tendency to provide the legislative acts through which these constitutional provisions are put in place with a higher status. Thus, the Constitution of Spain stipulates that an organic law shall develop the principle of budgetary stability, “together with the involvement, in the respective procedures, of the bodies for institutional co-ordination between Public Administrations on fiscal and financial policy matters. It shall, in any event, regulate: a) the distribution of the deficit and debt ceilings between the various Public Administrations, the exceptional cases in which said ceilings may be overrun and the way and term in which the possible deviations over one or other ceiling shall be corrected; b) the methodology and procedure for calculating structural deficit; c) the liability of each Public Administration in the event of a breach of budgetary stability targets” (Art. 135[5]). The Constitution of Slovenia provides that the manner and the time frame of the implementation of the principle of balanced revenues and expenditures, the criteria for determining exceptional circumstances that allow for temporary deviation from this principle, 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” (Art. 148 [2] and [3]).

Finally, in order to ensure that the numerical fiscal rules are respected, the Constitution of Slovakia, among others, provides for political sanctions. “1) If the debt is between 50% and 53% of the gross domestic product, the Ministry of Finance shall send a letter to Parliament with an explanation of the amount of debt, as well as proposals for measures to reduce it. 2) If the debt is between 53% and 55% of the gross domestic product, the Government shall submit to the Parliament a proposal of measures aimed at reducing the debt, and the salaries of the Cabinet ministers shall be reduced to the level applicable in the previous fiscal year. 3) If the debt is between 55% and 57% of the gross domestic product, the Ministry of Finance shall set aside 3% of the total state budget expenditures (other than those of the government debt service, the EU funds, contributions paid to the EU, and transfers to the Social Insurance Agency). At the same time the Government may not propose to the Parliament a draft state budget featuring any nominal year-on-year increase in general government expenditure (except in the aforementioned categories), and local governments are required to approve budgets with expenditures not exceeding those in the previous year’s budgets. 4) If the debt is between 57% and 60% of the gross domestic product, the Government may not submit to Parliament a deficit-based budget of the general government,

while local governments are required to approve a balanced or surplus budget for the next fiscal year. 5) If the debt is above 60% of GDP, in addition to the steps described above, the Government shall ask Parliament for a vote of confidence.”²³

4. NORMATIVE AND INSTITUTIONAL IMPLICATIONS OF THE CONSTITUTIONAL ENTRENCHMENT OF NUMERICAL FISCAL RULES

From a structural point of view, the constitutionalisation of numerical fiscal rules has changed a number of traditional constitutional domains: the system of the sources of law (4.1); the separation of powers (4.2); the distribution of powers (4.3); and the judicial review of constitutionality (4.4).

4.1. System of the sources of law

The introduction into constitutions of a balanced budget and public debt control requirements limits the powers of the legislature and executive to deal with public borrowing and expenditure. Legal norms, which were once regulated by ordinary laws, have now gained the status of constitutional law. This is particularly the case with specific numerical fiscal constraints on devising budgetary laws, but it also concerns other important rules such as the stipulation of exceptional circumstances under which derogating measures are permitted. Alternatively, constitutions provide that certain subject matters have to be regulated by organic or ordinary laws. These (organic) legislative reservations remove certain matters from the realm of the executive, thereby increasing transparency, legitimacy, and especially time consistency of public policies. It should be pointed out here that the rule is that only law can authorize the contracting of loans or assuming surety obligations, guarantees, and other commitments. These new constitutional constraints are likely to have an impact on the budgetary policies of various European states, “notably in countries like Italy or Spain where political elites have traditionally been less concerned with the sustainability of public finances, and have repeatedly subsidized government spending by raising public debts” (Fabrini 2013, p. 20). Finally, some strictly political issues, related to the responsibility of the executive branch in the parliamentary system of government, have been constitutionalised and tied to numerical fiscal constraints. These include, notably, the obligation of the government to face a confidence vote in the parliament if the public debt exceeds a certain level.

²³ Slovak Fiscal Responsibility Act. Quoted in: Stability Programme of the Slovak Republic for 2012-2015, 52. Available at http://ec.europa.eu/europe2020/pdf/nd/sp2012_slovakia_en.pdf. Last visited on 6 September 2016.

4.2. Separation of powers

In addition to the general implications for the overall system of sources of law, the constitutional changes have specific consequences for the relationship between the executive and legislative branches of government in the parliamentary system. Firstly, the executive is bound to propose, and legislatures to approve, budgetary laws requiring either a surplus or a balanced budget, or at worst a deficit not exceeding that permitted by the numerical fiscal constitutional constraints. It follows that these rules reduce the manoeuvring space for both executive and legislative branches. In practice this is always more problematic for the executive branch, as it limits its capacity to spend in order to gain political support. It also provides instruments for the parliamentary opposition to be heard, since it makes public policies more transparent and open to scrutiny. This is particularly the case in Slovakia, where every increase in the public debt above a certain level imposes on the Ministry of Finance and the government the obligation to take adequate action before parliament, as well as a confidence vote. However, some take the view (Fabriani 2013, p.20) that in parliamentary systems with coalition governments where the budget is the result of political bargaining between the government and parliamentary leaders, the introduction of numerical fiscal rules will likely strengthen the position of the executive branch vis-à-vis parliament.

4.3. Distribution of powers

Constitutional numerical fiscal rules have implications for both the horizontal and the vertical separation of powers, as they affect the public administration budget in general. The latter includes the national government budget and the budgets of other territorial entities (municipalities, regions, federal units), whose number and type depend on the level of decentralization of the state in question. An example of this is the provisions in the Spanish constitution which stipulate that “neither the State nor the Autonomous Communities shall enter into a structural deficit beyond the limits stipulated, if applicable, by the European Union for its Member States” and that “Local Authorities shall present a balanced budget” (Art. 135[2]). The reason for such a wide application of the balanced budget principle is that the amount of public debt for the total public administration is part of the nation’s gross domestic product. It follows that the numerical fiscal constraints contradict another prominent feature of constitutional democracies: the political and financial autonomy of its territorial entities. For instance, the European Charter of Local Self-Government stipulates that “local authorities shall be entitled, within national economic policy, to adequate financial resources

of their own, of which they may dispose freely within the framework of their powers” (Art. 9 [1]).

4.4. Judicial review of constitutionality

The constitutionalisation of numerical fiscal rules inevitably makes the specific numerical fiscal constraints justiciable. The application of both the system of the sources of law and the separation or distribution of powers is controlled by numerical fiscal rules that may be invoked before a constitutional court. Reviewing the constitutionality of these fields is normal in the judicial practice of constitutional democracies; however, the constitutional courts are likely to come out of the global financial crisis with a new role as guardians of fiscal discipline.

Although empowered and strengthened by these constitutional developments (see subsection 3.2), the extent to which the constitutional courts are willing and ready to embrace their new jurisdiction remains in doubt. They are generally reluctant to engage in the adjudication of controversies of a strictly political nature, such as those involving budgetary provision. For instance, the United States Supreme Court, one of the world’s most active constitutional courts, remains deferential to the federal government on matters of public policy, including economic policy (Lasser 2005, p.754). Interestingly, Portugal’s Constitutional Tribunal recently blocked certain budgetary measures adopted in response to the economic crisis, but on the grounds that they “failed to comply with the principle of equality as demanding a proportional sharing of the burden of the public charges” (Fabrini 2014, pp.101-103).

Regardless of constitutional courts’ activism or restraint in their role as controllers of budgetary policy, the question remains as to whether they have the capacity to apply the complex economic variables contained in the numerical fiscal rules (Fabrini 2013, p.22). There also remains the question of the effect of a retroactive constitutional court ruling against a budget many years after its enactment, and, more generally, the adaptability of the a posteriori review of constitutionality to the specificities of the numerical fiscal rule proceedings.

5. CHALLENGES TO THE CONSTITUTIONAL ENTRENCHMENT OF NUMERICAL FISCAL RULES

It follows that the constitutionalisation of numerical fiscal rules has important normative and institutional implications for constitutional democracies. It

nominally affects a number of constitutional domains: sources of law, horizontal and vertical separation of powers, and the judicial review of constitutionality.

However, its practical value remains to be seen, i.e., how effective it will be. Constitutional doctrine remains somewhat sceptical, questioning whether it is possible to respond meaningfully to economic problems by resorting to legal and especially constitutional mechanisms. The problem with the numerical fiscal rules, according to Garlicky (2014), is that they rely on a “positive-thinking” constitutionalism, based on the premise that it is sufficient to constitutionalise a rule in order to ensure a healthy economy. In the same spirit, Maus (2014) points out that the rules strive to impose discipline and reasonableness by legal or, more precisely, constitutional means where the interplay of politics and economics has failed to give results. Reservations appear to be particularly strong regarding the effectiveness of the judiciary blocking budgetary measures, and political sanctions for the executive branch when the numerical fiscal constraints are violated.

Leaving aside the arguments about its effectiveness, other considerations focus on the fact that numerical fiscal rules remove legitimate issues from political institutions’ agendas, limiting the sovereignty of national parliaments in budgetary matters and the political and financial autonomy of regional and local bodies. It constitutionalises, and therefore sets in stone, matters that should be open for discussion and political decision-making. According to this line of thought, it is impossible to say what is the desirable level of public debt in an ideal society. There is no absolute certainty, and only democratic debate that takes into account the objectives and concrete challenges of any given society can lead to answers to this question (Piketty 2014).

In response to this, it can be argued that the constitution-amending process is far more democratic and legitimate than the ordinary legislative process: it is more transparent and requires a qualified majority in parliament, or even a popular vote. In fact, pursuing excessive public debt is particularly worrying from the democratic perspective and calls for appropriate constitutional solutions. Firstly, countries that do not have balanced budgets and take out loans in the international financial markets to finance their public deficit risk curbing their sovereignty. For instance, the Fiscal Compact provides for majority decision-making, in a generally intergovernmental framework, and for the intervention of the troika in various matters of domestic politics, considered as issues of national sovereignty. Accordingly, excessive public deficit contributes to the rise of transnational constitutional regimes, which subverts the very idea of constitutionalism since only a nation state possesses “the social substrate that could provide a suitable

object for a constitution” (Teubner 2015, p.59). More precisely, nation states are de-constitutionalised by the transfer of government functions to the transnational level, which in itself does not have a democratic mandate for its rule.

Secondly, pursuance of excessive public debt violates the principle of generational sovereignty. The history of constitutionalism, from England’s Magna Carta Libertatum to the United States’ Declaration of Independence, is closely tied to the principle of no taxation without representation. When the government of one generation creates a financial burden repayable by later generations, it effectively engages in an act of taxation without representation. The problem of inherited public debt was noted by Thomas Jefferson, who insisted that “no generation can contract debts greater than may be paid during the course of its own existence” and that “19 years is the term beyond which neither the representatives of a nation, nor even the whole nation itself assembled, can validly extend a debt”.²⁴ Following this line of argument, he went even further to claim that “one generation is to another as one independent nation to another”.²⁵

6. NUMERICAL FISCAL RULES IN SERBIA: EXPERIENCES AND LESSON LEARNED

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

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

According to this law, public debt 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 shall submit a programme of debt reduction to the parliament (as part of the budget documentation).

²⁴ Thomas Jefferson to James Madison (1789), Memorial Edition (Lipscomb and Bergh, editors), Washington D.C., 1903-04, 7:455. Quoted in: <http://famguardian.org/Subjects/Politics/thomasjefferson/jeff1340.htm>. Last visited on 6 September 2016.

²⁵ *Ibid.* 7:454

b) The deficit rule is defined by the following formula:²⁶

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

where d_t and d_{t-1} are deficits (in percentage of GDP) in years t and $t-1$, d^* is the targeted long-term deficit (defined in the law at 1%), while g_t is the 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%.

Consequently, when the law was adopted the formula looked as follows:

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

c) The law introduced indexation rules (effectively ‘freezing’) for public sector wages and pensions for the 2011–2015 period as a measure for controlling fiscal expenditure. It stipulates that these rules shall also apply post-2015 until the pensions stake in GDP drops below 10% and the wages stake drops below 8%.

The law also specifies an important exception for capital expenditure, i.e., public investment: if the share of capital expenditure is above 4% of GDP in 2011, or above 5% in 2012–2015, the portion above this threshold shall not be counted as deficit. However, it cannot be more than 2% of the GDP in total, thus further complicating the rule.

The law has been amended nine 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 deficits were not amended, as in fact they did not represent an obstacle).

There are several flaws with the rules as defined.

a) The deficit rule is too complicated.

One of the main characteristics of a good rule is that it is clear so it is easily observable whether the rule has been violated or not. That is not the case with

²⁶ The deficit in question is the consolidated public deficit that includes the general government budget, autonomous province budgets, local authority budgets, and public funds (health insurance, pension insurance, and social security).

the Serbian deficit rule. It requires a certain level of mathematical knowledge to understand the formula, let alone to actually calculate the permitted deficit. Consequently, the general public, the media, and politicians almost completely ignore this rule in public debate as too complicated. All of the focus is on the debt rule, due to the fact that it is simple and straightforward.

b) The deficit rule is very difficult to implement, since d_{t-1} and g_t are forecasts, not actual/historic figures.

The budget is usually prepared in the autumn, when the main aggregates for the next year (such as total deficit) need to be defined and the actual numbers for the current year are still unknown. This 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. This also means that the government has substantial latitude in this process.

Similarly, g_t is also a projection. Since every percentage point of deviation from the 4% long-term growth rate provides an additional 0.4% GDP deficit, the government is incentivised to project a lower expected growth rate. On the other hand, this may balance the government's incentive to project a higher expected growth rate when forecasting revenues.

c) The debt ceiling lacks credibility, as when the law was adopted (October 2010) the debt was already above 40% of GDP.

It is unclear why the 45% ceiling was adopted when the public debt was already very close to that ceiling. Basically, the only justification for such a decision was that the government was certain of the success of the pending Telekom privatisation and that a large share of the privatization proceeds would be used to reduce the debt and/or finance the deficit, without new spending. However, the Telekom privatisation fell through, and the rule was broken within a year of its adoption. If this explanation is correct, it is testimony to a myopic government that enacted a debt-ceiling rule while only taking into account the near-term future.

d) Deficit numbers are easily manipulated.

Budget accounting in Serbia is still cash-based, with unclear rules and practices regarding which items should be treated as revenue/expenditure ("above the line") and which items should be treated as financing operations ("below the line"). This

means that the government can easily hide the actual deficit by shifting spending below the line, or shifting some receipts as revenue above the line.

- e) The debt rule does not clearly define when the debt/GDP ratio should be calculated and what GDP should be taken into account.

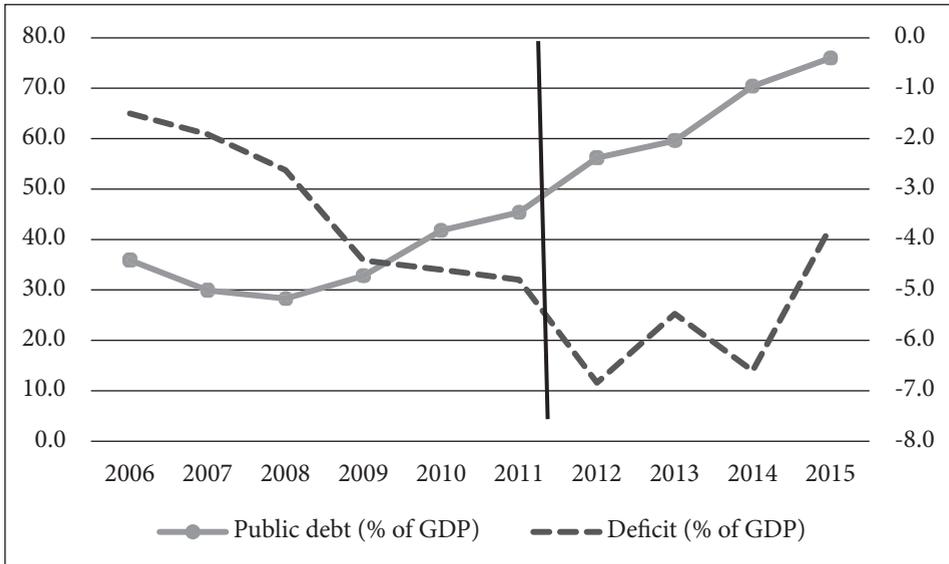
Nominal GDP in Serbia is calculated and presented once a year, and it can take more than twelve months after the conclusion of that year for the official figures to be published. This means that the current debt/GDP ratio is always based on a projection of GDP. That is probably a problem in itself, but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

- f) The most important flaw in the Serbian fiscal rules is that they are specified by a law.

An ordinary law simply cannot limit the power of the National Assembly, as the National Assembly can adopt any legislation that complies with the Constitution. For example, although the Budget System Law determines that the deficit cannot be higher than a given formula-defined level (for example, 3% of GDP), parliament can still adopt an annual budget that envisages a deficit of 4% per year, and there is little that can be done about it. Thus, any numerical fiscal rule determined specified by a law cannot be effectively enforced, and therefore is only wishful thinking and not a legally binding constraint.

Unsurprisingly, the effect of the Serbian numerical fiscal rules has been 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 only was the deficit not reduced, but it actually increased following the adoption of the law, resulting in a continuous increase in the public debt.

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



Source: Ministry of Finance of Republic of Serbia

7. DESIRABLE FEATURES OF NUMERICAL FISCAL RULES

According to Kopits and Symansky (1998) an ideal fiscal rule should have the following characteristics: it should be well-defined, transparent, simple, sufficiently flexible, in line with the ultimate goal, appropriate, consistent, and in accordance with planned structural reforms. The authors believe that there are obvious trade-offs between these desirable characteristics: the right balance needs to be found. In a review of state-level debt and the deficit in the USA, Bohn and Inman (1996) suggest the following four characteristics of good fiscal rules: an appropriate moment to verify compliance with the rule (beginning or end of the year); easy to verify whether the rule is violated by circumvention; a strong enforcement mechanism; the rule cannot be easily changed, and then only in exceptional situations.

The political economy of fiscal rules should be taken into account because it is expected of politicians, who want to spend other people’s money on their constituency, to self-impose the rules. Even if they impose the rules during an economic boom time, there is nothing to prevent the rules from changing when recession hits. It also requires that voters are sufficiently aware and well informed

in order to subsequently punish fiscally irresponsible governments. However, as demonstrated by Caplan (2007), this is rarely the case, because economic issues in general, let alone the details of fiscal policy, are usually of secondary importance to voters. This is especially the case if the rules are too complicated to be understood by the layperson and if there is room for interpretation of what happened.

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

Therefore, the rules should be flexible enough to allow some discretion in exceptional circumstances, but it is important to define the exceptions very precisely. Also, there is a trade-off between flexibility on the one hand and the simplicity and comprehensibility of the rules for the lay person on the other hand. For example, completely prohibiting deficits is very clear and precise, but not only does it limit discretion but it also directly imposes procyclical fiscal policy. On the other hand, if the requirement 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 correcting the deficit by the stage of the business cycle is a very controversial area of macroeconomics and provides great latitude in decision-making.

Rules can be manipulated in other ways. For example, the government can always achieve a 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 anything from the legal standpoint.

One of the key conditions for the rule to be successful is a good balance between the rules being effective and being simple/comprehensible. On the one hand, the rules should make economic sense, i.e., have a beneficial impact on the national economy in order to get the support of voters and their elected representatives. However, the rules should also be clear and simple, and it should be easy to monitor their implementation and to reduce the scope for discretion and manipulation. The optimal balance between the two features in all probability depends primarily on the institutional environment in which the rules are enforced, i.e., the country's administrative capacity, as well as the level of local political awareness.

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

When it comes to numerical fiscal rules, a distinction can be made between hard and soft rules. Essentially, ‘hard’ rules are legal rules which can be raised in the courts and enforced, while ‘soft’ rules are legal rules that cannot be judicially enforced. Thus, the observance of soft numerical fiscal rules is monitored by the public (constituency and/or taxpayers), politicians (both those in power and those in opposition), and by the financial markets, which may (though not necessarily) ‘punish’ fiscally irresponsible governments by increasing the costs of borrowing. In that sense, although Serbian fiscal rules are defined by law, they are effectively soft rules as their enforcement does not rely on the courts.

Of course, there is a link between the strength of the rules (‘hard’ or ‘soft’) and how well they are developed. If the rules are soft, then they should be simple and not well developed, since the ‘penalty’ for their violation comes from relatively unsophisticated voters and politicians. If the rules are ‘hard’ they should be very detailed and well developed. However, such rules 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 definition of the meaning of the term “structural deficit”, of how it is calculated, i.e., how the structural deficit is separated from the total, of how the GDP is calculated, etc., so that the court can adjudicate appropriately.

The optimal level of complexity is that which represents the optimal trade-off between complexity and transparency of the rules, and this 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 in countries where the institutional development level is higher, while simpler rules are more likely to be suitable for institutionally less-developed countries with small administrative capacity. For example, if there is widespread suspicion in the 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 for them to be simple. On the other hand, when administrative capacity allows for the implementation of the rules they can be more complex.

8. PROPOSALS FOR SERBIA

The constitutionalisation of numerical fiscal rules raises a number of important normative and institutional issues, from how legitimate it is to how effective it can be. These issues are closely interrelated. The legitimacy of constitutional numerical fiscal rules depends on how they are formulated and what constitutional mechanisms are put in place for them to be as effective as possible.

The proposals presented in this section are based on a few observations of Serbia.

- (1) Law-based numerical fiscal rules are not likely to be effective in Serbia, as the National Assembly is able to adopt new legislation that undermines the rules or even amend the legislation that provides these rules.
- (2) Serbia does not have a well-developed, efficient, and independent civil service, and therefore lacks the administrative capacity required for swift, efficient, and impartial enforcement of fiscal rules. Perhaps the most troublesome is the National Statistical Office, crucial for the enforcement of complicated fiscal rules. The administrative capacity of the Ministry of Finance is also low and unfortunately decreasing. Though the contribution of the Fiscal Council to sound public finances in Serbia is significant, this authority is still institutionally young and fragile.
- (3) The Serbian constituency prefers simple political issues rather than complex, difficult issues and issues that are not perceived to directly affect the welfare of the voter. The average Serbian voter has a limited capacity for absorbing the abundance of specific information necessary for dealing with the fiscal process, its outcomes, and the implications of long-term economic progress for the country and the voter's improved welfare.

Following observation (1), Serbia should introduce constitutional constraints, i.e., numerical fiscal rules should be introduced into the Constitution. The law should only stipulate the technical details of the enforcement of the fiscal rules. The Constitution should introduce 'organic' law as a type of legislative act superior to ordinary legislation, and stipulate, specifically, that all relevant details of the numerical fiscal rules should be elaborated in an organic law. Furthermore, the Constitution should include a provision stipulating that only a law can authorize

the contracting of loans or the providing of sovereign guarantees and financial sureties. Finally, the Constitution should also provide for exceptions to the rules in emergency situations.

Following observations (2) and (3), the proposed rules must be simple, understandable, and straightforward, with minimum latitude in their implementation. This limits the options for the main target of fiscal control. One option is a (consolidated) structural fiscal deficit, as total deficit might not be a good target due to the ‘straightjacket’ that it creates in times of recession, with limited opportunity for countercyclical fiscal policy. Section 3.2 of this paper has shown that in Germany, Slovenia, and Spain the fiscal rule only targets structural deficit.

Targeting structural fiscal deficit creates two methodological issues:

- Identifying the stage of the business cycle;
- Identifying one-off factors in both revenue and expenditure.

All countries that target structural deficits face these problems, but there is a lack of administrative capacity in the Serbian authorities in charge of fiscal policymaking (primarily the Ministry of Finance) and monitoring macroeconomic developments (primarily the Statistical Office). Furthermore, these authorities are not independent of the executive and legislative branches of government, creating the risk that these branches will influence decisions concerning, for example, the stage of the business cycle, with substantial consequences for a fiscal deficit that is in compliance with the numerical rules. Moreover, the Constitutional Court, which would be in charge of enforcing these rules, would inevitably base its decisions on calculations delivered by these authorities, which would inevitably undermine the Court’s independence.

The significance of accurately identifying Serbia’s structural deficit is that the country still expects considerable privatisation proceeds from the sale of state-owned equity and assets. The proceeds of privatisation are not considered to be fiscal revenue, and therefore are used only for financing the public deficit. This implies that the proceeds of privatisation cannot be used for any additional budgetary expenditures. Nonetheless, the rule of thumb is that privatisation proceeds should not be used to expand any recurring expenditure, i.e., entitlements (pensions, public sector wages, social programmes, etc.), but should be used exclusively for one-off expenditures like public investments.

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

The enforcement of such a numerical fiscal rule leaves some open methodological issues, most of them based on the classification of sovereign debt; i.e., whether a given obligation should be classified as sovereign debt, and, above all, the status of sovereign guarantees. The current Serbian Public Debt Law treats all issued guarantees as public debt, even in cases when the borrower (most commonly state-owned enterprises) is perfectly capable of servicing the debt. In some other legal systems, only called guarantees are included in the debt. Our recommendation is that Serbia proceed with a more conservative approach: all issued guarantees should be considered as public debt.

In addition, deposit insurance creates budgetary obligations, and these obligations must be serviced by the budget in the event of bank failure. Common contemporary practice is to not include insured deposits in the sovereign debt, even though the insurance creates fiscal risk. The main difference between sovereign guarantees (which should be included in the debt) and deposits that are insured is that the deposit insurance premium is paid to the Deposit Insurance Agency, which is obliged to pay the insured amount of deposit to the depositor if the bank fails. Only if the Agency's insurance fund is insufficient to cover all insured deposits does the government step in and supplement the amount owed to depositors. Although there is some fiscal risk in deposit insurance, the insured deposits should not be included in the sovereign debt. This is already confirmed in the Public Debt Law, and that law should not be amended regarding the status of insured deposits. However, if this fiscal risk does occur (a bank fails), under the fiscal rule, payments and liabilities arising from deposit insurance will consume part of the deficit and/or debt space.

Another methodological dilemma is the treatment of public-private partnerships (PPP). Effective numerical fiscal rules will provide more incentive for the government to enter PPPs as a way of avoiding increased direct debt. The crucial issue here is how the risk is treated, as it is distributed between the public and the private partner. Take the example of a toll highway concession contract, which includes the provision that the government guarantees minimum traffic of 12,000 average annual vehicles per day, and if the traffic turns out to be below

that threshold the government is obliged to pay the difference in toll revenue. This is an additional fiscal deficit, and creates sovereign debt. As in the case of deposit insurance, this kind of fiscal risk cannot be dealt with by classifying it as sovereign debt, if for no other reason than because the figure of the deficit/debt is not available *ex ante*. Nonetheless, if the debt ceiling has already been reached, the National Parliament cannot ratify these PPP contracts (international and domestic), as they would be in violation of the fiscal rule. If they are ratified by law, that law will be in violation of the Constitution.

A fiscal rule that establishes a permitted level (ceiling) for the sovereign debt-to-GDP ratio creates the huge fiscal risk of a fiscally irresponsible government borrowing excessively when the level of the sovereign debt-to-GDP ratio is low. Accordingly, the pace of the fiscally irresponsible government borrowing should be checked and balanced. The best way to achieve this is to design a fiscal rule that constrains annual net new borrowing by the government, i.e., annual incremental debt, or the debt increase during the year. If the net new borrowing is negative, the level of debt decreases. Net new borrowing does not necessarily equal fiscal deficit, as there are one-off revenues (receipts) that are not classified as budgetary revenue, such as privatisation proceeds from the sale of either capital or assets. With privatisation proceeds, net new borrowing is lower than the total deficit.²⁷

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. For example, if the debt-to-GDP ceiling is 60%, then applying the net new borrowing ceiling scheme as illustrated in Table 2 is recommended.

Table 2: Ceiling of annual net new borrowing

Level of sovereign debt (% GDP)	Ceiling of annual net new borrowing (% GDP)
Below 50%	2%
50%-60%	1%
Over 60% (ceiling violated)	No new net borrowing

Changing the ceiling for annual net new borrowing produces the following outcome: if the government indulges in the maximum amount of annual net borrowing every year, whatever the debt level, it takes at least ten years to reach

²⁷ A rule of thumb for sound fiscal policy is that the proceeds of one-off privatisations should not be used to finance deficit in recurrent payments, i.e., entitlements. Instead, these proceeds should be used for one-off outlays, e.g., capital expenditure or (prematurely) paying-off debt.

the debt-to-GDP ratio ceiling. That period is longer than the two constitutional mandates of the (executive) government.

Finally, in order to remove any ambiguity, the ceiling of the debt-to-GDP rule should have priority over the annual net new borrowing rule. This means that if the level of the debt-to-GDP ratio is 59.5%, the ceiling for the net new borrowing in that year is 0.5% of GDP. The same effect can be achieved if both rules are a cumulative condition for new net borrowing.

The structure of the proposed fiscal rules provides a solid foundation for fiscal discipline. Nonetheless, it is evident that if the debt-to-GDP ratio is close to the ceiling (above 50% of GDP), the space for fiscal deficit as the basis of countercyclical fiscal policy is very limited (net new borrowing of only 1% of GDP). Furthermore, if the debt-to-GDP ratio is very close to the ceiling, a decrease in GDP due to recession will prevent the government from running any fiscal deficit, undermining countercyclical fiscal policy. To prevent this an additional rule should be introduced: in the case of a recession (negative growth rate in two consecutive quarters) the net new borrowing ceiling will be increased by up to 2% of GDP. This increase would be limited to the year in which the recession is recorded (via budget rebalancing), and to the new year(s) in a recession that is still ongoing at the end of that year (at the time of adopting the budget).

This proposal should be considered within the following framework. First, it creates a strong disincentive for governments to run huge fiscal deficits during boom periods and for the deficit to be used as a demand management tool. Second, as the state still owns capital and property of substantial value, selling that property during a recession can lead to fiscal expansion, as a 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 the fiscal multiplier in Serbia is low, its impact rather negligible, and the demand side for growth should be net exports (Petrović 2011) rather than an aggressive fiscal stance. Accordingly, the proposed solution of a numerical fiscal rule provides for sufficient countercyclical fiscal policy during recession.

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 paper. A 60% ceiling has been used only as an example to calculate a decreasing ceiling for annual new net borrowing, taking into account EU fiscal rules. This issue is linked to the issue of debt sustainability, which is rather complex and tricky (IMF 2013) as many

factors need to be taken into account. The best way forward would be for the Fiscal Council to specify the ceiling for the Serbian debt-to-GDP ratio as part of the preparation for the proposed amendments to the Constitution.

If the debt-to-GDP ratio ceiling is substantially lower than the existing sovereign debt level, a transitory period should be included in the Constitution. Only the period (e.g., 10 years) should be specified, leaving the government to run fiscal policy so as to bring the Serbian debt-to-GDP ratio below the constitutionally specified level.²⁸ In the interim prior to the enforcement of the constitutional limit of the debt-to-GDP ratio the regime should be an effective numerical fiscal rule for Serbia.

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

The ceiling of the debt-to-GDP ratio may be violated for a number of reasons that are not under direct government control. For example:

- A change in the RSD exchange rate, as well as in the exchange rate between the currencies that the Serbian debt consists of²⁹
- A decrease in GDP due to recession
- A decrease in the GDP due to its recalculation³⁰
- An increase in the debt, due to the activation of some government obligations; e.g., deposit insurance, risk allocation in PPPs, etc.

In all these cases, if the ceiling of the debt-to-GDP ratio is violated, any new net borrowing will violate the fiscal rules. However, as the debt increase is not

²⁸ If the debt-to-GDP ratio ceiling is set at 60%, with actual Serbian sovereign debt at 76%, an adjustment programme with different growth rates (1%–4%) can reduce the debt-to-GDP ratio below 60% with a rather balanced budget, without any need for huge fiscal surpluses.

²⁹ Only a small share of the Serbian debt is actually issued in local currency. This means that the country is substantially exposed to exchange rate risk. The changes can go both ways: they can increase as well as decrease the level of the debt-to-GDP ratio without any new borrowing or repayment of the debt.

³⁰ Data on the GDP level is only available ex post. The ceiling is based on an estimate of the GDP, so changes are possible. Apart from that, recalculation of Serbian GDP has been quite common in the past few years due to many factors that are beyond the scope of this paper. More recalculations can be expected in the years to come.

caused directly by Government and/or Parliament the action would not be ruled unconstitutional.

The enforcement of the proposed constitutional numerical fiscal rules, bearing in mind the Serbian Constitutional Court's capacity to review such acts, remains an ongoing problem. The Court's approach to understanding the acts that are subject to its jurisdiction is too formalistic. To remedy this, the procedure for contracting loans and providing sovereign guarantees and financial sureties should be established in organic law. The organic law should specify that all acts intended to have the effect of loans, sovereign guarantees, and financial sureties, but which are not concluded in the stipulated form, are to be declared void. Furthermore, preventive control should be introduced for budget and loans contracts with sovereign guaranties and all operations that increase the public debt.

The Fiscal Council should be allowed to bring cases before the Constitutional Court. In this way, the Court will have the assistance of expert and unbiased views. This control should be preventive. Additionally, the Fiscal Council should be consulted on the value of the specific numerical fiscal constraints to be introduced for the budget. Finally, it should also be possible for a certain number of MPs (1/5 instead of the 1/3 under the current Constitution) to introduce preventive control.

9. CONCLUSION

The recommendation of establishing numerical fiscal rules for Serbia is based on the inherent bias in fiscal policy towards expenditure, and consequently continuous fiscal deficit and excessive sovereign debt. In the case of Serbia, hard numerical rules are superior to soft numerical rules due to the long tradition of Serbian legislators' substantial latitude vis-a-vis the decision-making process, especially budgeting. The rules should be simple and comprehensible, with little latitude in implementation. Therefore, the recommendation is for simple and straightforward numeric fiscal rules to be introduced into the Constitution. There should be two cumulative numerical fiscal rules, the primary one regarding the sovereign debt ceiling, and the secondary one regarding the net new borrowing ceiling. Neither of the rules may be violated. The debt level ceiling should be prescribed by the Constitution. The new net borrowing ceiling should depend on the distance of the sovereign debt from the debt ceiling. An illustrative example with a debt ceiling of 60% is provided. Nonetheless, the Fiscal Council

should specify a specific sovereign debt ceiling as part of the constitutional amendment proposal, taking into account fiscal deficit projections and debt sustainability analysis. Accordingly, this contribution remains silent on the specific constitutional debt ceiling for Serbia.

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