Fiscal Deficit and Public Debt in the Western Balkans: 15 Years of Economic Transition

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by Zsoka Koczan

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I N T E R N A T I O N A L M O N E T A R Y F U N D

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Prepared by Zsoka Koczan¹

Authorized for distribution by Zuzana Murgasova

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Abstract

In this paper we analyze how Western Balkans public finances adapted to the boom-bust cycle. Large capital inflows into emerging European economies during the mid-2000s resulted in rapid economic growth and convergence to EU income levels. This also resulted in improved fiscal positions of most countries, on the back of strong revenue performance. Yet, since the onset of the global economic crisis, many countries have struggled to adjust to the new situation of lower external financing and lower growth.

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Author's E-Mail Address: ZKoczan@imf.org

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I. INTRODUCTION

In the past decade, most of Emerging Europe experienced a severe boom bust cycle. Several papers have examined the experience of the New Member States, arguing that their credit boom-bust cycle was to a large extent the result of factors external to the region. Rapid credit growth followed from high liquidity in global markets and the attractiveness of “new Europe” for capital flows, while the end of the credit cycle was brought about by a global crisis. However, overly expansionary macroeconomic policies and underestimation of prudential risks also contributed to the crisis (see e.g., Bakker and Gulde 2010, Roaf et al., 2014).

Very little has however been written on the experience of the Western Balkans. In this paper we examine how public finances in the Western Balkans adapted to the boom-bust cycle, and how this compares to the experiences of the New Member States. We analyze policies in the boom years of the early 2000s, the impact of the crisis, and how countries have adapted in its aftermath. We find that, as in the New Member States, the boom years were associated with good fiscal positions. However, headline figures masked underlying vulnerabilities. The crisis led to a particularly sharp decline in revenues in the Western Balkans, which, together with difficulties in scaling back spending, resulted in a significant deterioration in fiscal positions and a build-up of debt. The Western Balkans has struggled to adapt to the new environment, and remains characterized by rigid expenditure patterns.

II. THE BOOM YEARS¹

Rapid economic growth improved the fiscal positions of the Western Balkans states in the early 2000s. As growth picked up across the region, rising revenues in most countries more than offset increasing government expenditures. This in turn helped improve overall fiscal positions and led to reductions in general government debt across the board (Table A.1). Previously-very-high government debt fell to levels comparable to Central and Eastern European economies by 2008.

Most of the Western Balkan states saw large increases in general government revenue as a percent of GDP prior to 2008, similar to the experience in many of the New Member States. Cyclical factors, resulting from strong economic growth and booming consumption, were partly responsible for strong revenues, despite discretionary cuts in tax rates in some cases. These cyclical factors were particularly sizeable in Montenegro and to a lesser extent Kosovo, Albania, and Croatia (see Figure A.1). However, important fiscal reforms were implemented in many Western Balkan countries, at times in the context of Fund-supported programs, and played a key role in boosting revenues. These reforms included buildup of

¹ In all of the following, Western Balkans refers to Albania, Bosnia and Herzegovina, Croatia, Kosovo, FYR Macedonia, Montenegro and Serbia. Central and Eastern Europe includes Bulgaria, the Czech Republic, Hungary, Poland, Romania, Slovakia and Slovenia. The Baltics refers to Estonia, Latvia and Lithuania. Central and Eastern Europe and the Baltics will be referred to together as the New Member States.

Growth and fiscal positions
(2002-2008)

Source: World Economic Outlook.

institutional capacity and widening the range of tax instruments in Kosovo, improved tax collection efficiency and tax system simplification in Albania, unification of indirect tax policy and customs administration in Bosnia and Herzegovina (across the Federation of Bosnia and Herzegovina and the Republika Srpska) and virtual elimination of all exemptions. The revenue increase during the 2000s was less pronounced in Croatia and Serbia, where improvements in tax administration had started earlier.

Revenue in 2002 and 2008
(general government revenues as percent of GDP)

Source: World Economic Outlook.

VAT introductions

Country	Date VAT introduced
Albania	Jul 1996
Bosnia and Herzegovina	Jan 2006
Croatia	Jan 1998
Kosovo	Jul 2001
Macedonia, FYR	Apr 2000
Serbia and Montenegro	Apr 2003

Sources: International Bureau of Fiscal Documentation (www.ibfd.org).

Individual tax rates
(top individual tax rates, percent)

Corporate tax rates
(top corporate tax rates, percent)

Sources: The World Tax Database of the University of Michigan, KPMG Global Corporate Tax Rate Tables, IBFD Comparative Tables.

However, buoyant cyclical revenues and one-off receipts from privatization also increased the appetite for spending, especially in the run-ups to elections. As a result, government expenditures surged, particularly on public wages and pensions and ambitious infrastructure projects (Table A.2). Econometric analysis confirms that spending was less responsive to economic conditions (GDP growth and inflation) and debt levels in the Western Balkans than in the New Member States or the EU-15, and had a somewhat larger discretionary component (as proxied by spending unexplained by inertia or the business cycle; Box 1).

As a result primary balances strengthened across Emerging Europe, but to a lesser extent in the Western Balkans than in the New Member States. Yet debt ratios fell particularly sharply in the Western Balkans, which also benefited from debt forgiveness through Paris club debt reductions.

Box 1. Estimating Discretionary Fiscal Policy

Three main approaches have been followed in the literature for estimating discretionary expenditures: (1) looking at cyclically adjusted budget balances (Blanchard 2003, Girouard and André 2005), (2) obtaining discretionary expenditure from the estimated residuals of a total expenditure regression, determined by lagged expenditure (the inertial component) and some measures of economic activity to approximate cyclical components (Fatás and Mihov 2003, Afonso et al. 2010, Corsetti et al. 2012) and (3) through a “narrative” approach or event studies, looking at policy or administrative decisions (Ramey and Shapiro 1998, Romer and Romer 2010, Ramey 2011). Despite their wide use adjusted balances have several limitations – including not accounting for differences in government size, which are important for characterizing fiscal policy in a structural way, and overstating the ability of adjusted balances to remove cyclical fluctuations. The key drawback of identifying discretionary expenditure as residuals from an estimated equation is that this confines discretionary spending to an unpredictable shock, even though discretion and unpredictability are not synonymous, and discretionary spending may well react to the state of the economy. The narrative approach looks at policy decisions directly, however policy intentions may not always result in approved budget decisions, actual spending may not correspond to approved spending for the reference year and accrual accounting further complicated this analysis. While all three approaches have their drawbacks, our focus here is on the second since while this looks at a narrow measure of discretionary policy, it allows us to examine the potentially ‘harmful’ component of policy, extracting for instance the component driven by the political business cycle rather than by economic considerations. Focus here is on the expenditure side as with the exception of discretionary tax rate changes and lump-sum receipts revenues generally reflect their cyclical tax bases (Coricelli and Fiorito 2013).

We extract the discretionary component of fiscal policy by estimating a fiscal policy rule, quantifying the unexpected variation in fiscal policy. In line with the work of Fatás and Mihov (2003, 2006), Afonso et al. (2010) and Agnello et al. (2013) we estimate the following rule for each country i ($i = 1, \dots, N$) to obtain the discretionary component of government spending:

$$g_{it} = \theta_i + \lambda_i g_{it-1} + \beta_i \Delta y_{it} + \gamma_i \Delta y_{it-1} + \Gamma_i X_{it} + \varepsilon_{it} \quad (1)$$

where g is the logarithm of real government spending, y is the logarithm of real GDP and X is a set of controls including inflation and the logarithm of real public debt. We treat discretionary fiscal policy as the component of government spending that is not explained by persistence (captured using lagged spending), responsiveness to the business cycle (captured using current and lagged GDP growth) and other factors such as inflation and the level of debt. Thus λ_i is a measure of persistence; β_i and γ_i gauge the responsiveness of fiscal policy to the business cycle and ε_{it} is the unexpected discretionary variation in fiscal policy. We include country fixed effects to account for the impact of country-specific factors. We rely on a panel dataset including 34 countries (Western Balkans, EU).

Across all countries government spending exhibits a high degree of persistence, with lagged expenditure explaining most of the variation in current expenditure. Current GDP growth has a negative impact on spending, possibly capturing effects through lower revenues requiring corresponding spending cuts. Debt has a significant constraining impact on spending only in the EU-15 and the Baltics, but not in the Western Balkans and CEE. The discretionary component, treated here as the unexpected variation that could include factors such as windfall revenue gains or the political business cycle, appears to be somewhat larger for the Western Balkans, where less of the variation in spending for a given country over time is explained by cyclical factors and inertia.

Fiscal policy responsiveness, persistence and discretion					
	Full sample	WB	CEE	Baltics	EU15
<i>Log real expenditure (lagged)</i>	0.911***	0.872***	0.919***	0.898***	0.935***
	-0.012	-0.037	-0.035	-0.046	-0.015
<i>Change in log real GDP</i>	-0.843***	-0.336	-0.523**	-0.984***	-1.140***
	-0.07	-0.267	-0.177	-0.127	-0.107
<i>Change in log real GDP (lagged)</i>	0.172*	0.203	0.189	0.333*	0.068
	-0.068	-0.212	-0.175	-0.148	-0.106
<i>Inflation</i>	-0.005***	-0.004***	-0.007**	-0.005**	-0.007***
	-0.001	-0.001	-0.002	-0.002	-0.002
<i>Log real debt</i>	-0.031***	-0.012	-0.013	-0.062*	-0.043***
	-0.007	-0.033	-0.014	-0.026	-0.008
<i>Constant</i>	0.491***	0.498*	0.363*	0.435*	0.518***
	-0.063	-0.214	-0.147	-0.191	-0.082
<i>Number of obs.</i>	631	95	119	49	336
<i>Number of fixed effects (countries)</i>	34	7	7	3	15
<i>R-sq within</i>	0.935	0.902	0.948	0.966	0.942
<i>R-sq between</i>	0.899	0.993	0.995	0.877	0.631
<i>R-sq overall</i>	0.909	0.974	0.950	0.911	0.847

Note: The dependent variable is log real expenditure. Standard errors in parentheses, * denotes significant at the 5 percent level, ** at the 1 percent level, *** at the 0.1 percent level.

III. THE CRISIS AND ITS AFTERMATH

The onset of the crisis in 2008 revealed underlying fiscal vulnerabilities in many emerging European countries. A sharp decline in capital inflows led to economic recessions and modest recoveries thereafter. In this context, part of the revenue surge of the boom years turned out to be temporary, and set the stage for large deficits across the Western Balkan countries. The collapse in tax revenues was particularly marked for taxes on goods and services and international trade and transactions, which account for a higher share of revenue in the Western Balkans than in the EU-15 or New Member States.

Most of these countries lacked the fiscal space and the financing to accommodate falling revenues, and thus resorted to pro-cyclical fiscal tightening. A number of them restrained expenditures and/or increased tax rates. For example, Serbia reduced capital spending, Croatia introduced a VAT rate hike and a temporary “solidarity tax,” and both countries resorted to a wage and pension freeze. In contrast, Albania implemented a fiscal stimulus, in part financed from the privatization of the electricity distribution system. Kosovo showed considerable resilience to external turbulence due to limited economic linkages to crisis countries and robust remittances and FDI inflows. Nevertheless, Kosovo’s fiscal deficit also widened after the crisis due to capital spending on an ambitious highway project.

In the aftermath of the crisis, the Western Balkans experienced difficulties in regaining control of public finances. Unlike in Central and Eastern Europe, where current spending was reduced after 2009 (see e.g. Blanchard, Griffiths and Gruss, 2013), mandatory expenditures proved difficult to scale back in the Western Balkans, thus restricting the room for maneuver. In particular, public sector wage bills and pensions (in the economies with older populations), which constitute a larger share of overall spending in the Western Balkans, proved to be very rigid (Box 2). Furthermore, as public debts increased, interest payments also drifted up, approaching levels observed in Central and Eastern Europe. As a result, mandatory spending (on wages, pensions, and interest payments) is now much higher in the Western Balkans than in the New Member States or the EU-15, in particular in Albania, Croatia, FYR Macedonia and Montenegro, thus severely constraining the flexibility of the budget. While the other countries—Bosnia and Herzegovina, Kosovo and Montenegro—have lower levels of mandatory spending, they also have fewer policy tools due to the lack of independent monetary and exchange rate policy (Bosnia and Herzegovina has a currency board, Kosovo and Montenegro are unilaterally euroized). Capital expenditures, which had increased sharply in the boom years, were relatively easier to compress, and thus declined after the crisis.²

² Ambitious infrastructure projects, such as Kosovo’s and Montenegro’s highways, may however reverse this trend.

Precommitted spending as a share of total expenditures
 (compensation of employees, social security expenditures and interest payments as a share of total expenditures)

Source: World Economic Outlook, IMF data.

Debt has increased sharply in the Western Balkans in the past few years, reaching the levels of Central and Eastern European countries. The significant reduction of the debt burden that took place during the boom years was thus largely undone.

Box 2. Public Pension Spending in the Western Balkans 1/

Pension spending in most of the Western Balkans is much higher than in New Member States, amounting to almost 10 percent of GDP and almost a quarter of total government expenditure. The dominant system is a public pension scheme with compulsory contributions on a pay-as-you-go basis (the first pillar), which covers all workers in the formal economy. However, aging populations, low employment and participation rates, and a large informal economy threaten the sustainability of such systems. The widespread practice of early retirement that has accompanied privatization and enterprise restructurings has further worsened the situation.

Demographic and labor market indicators

Sources: World Bank, The Atlas of Social Protection: Indicators of Resilience and Equity and national authorities.

Note: Using latest available data (2004-2011). The economic support ratio is defined as the ratio of contributors to pensioners.

Old age contributors

Source: ILO.

Note: 2009-2011, depending on data availability.

NMS average excludes Romania due to lack of data.

Public pensions spending (Percent of GDP)

Source: Eurostat, national authorities.

Note: Data refer to 2012/2013.

Pension spending as a share of total government expenditure, 2013 (Percent)

Source: National authorities.

Box 2. Public Pension Spending in the Western Balkans (concluded)

Several countries have introduced pension system reforms, albeit with wide variation in their scope:

- Croatia and FYR Macedonia partly transformed the inherited redistributive universal pension systems into selective contributive systems, where the second pillar now replaces part of the first pillar social security pension. Third-pillar voluntary private pensions operate in Croatia, FYR Macedonia, Montenegro, and Serbia, but play only a small role.
- Serbia and Montenegro have instead focused on reforms to the existing pay-as-you-go system, changing indexation formulas, gradually increasing retirement ages and/or tightening eligibility criteria for early retirement, and reducing occupational and gender privileges. However, these reforms are unlikely to bring significant savings in the short run and the pension systems are still not sustainable.
- In Bosnia and Herzegovina, early reforms focused on harmonization between the two entities, and implementation of a new privileged pension law in the Federation is ongoing, focusing on reducing benefits, increasing the number of contributors, and raising the effective retirement age.
- Younger populations in Albania and Kosovo explain the relatively lighter pension burdens in these countries, though low employment rates and high levels of informality in these countries will contribute to increasing pressures as populations age. A combined first- and second-pillar system was created in Kosovo in 2002. In Albania contribution rate cuts, recent unfunded increases in benefits, and incentives for underreporting income led to an increase in the social insurance system deficit.

As a consequence of financing constraints, pensions across the region are low in relation to subsistence needs. Going forward, the Western Balkan economies should concentrate on increasing participation and employment rates, reducing informality, and supporting the development of second and third pillars to ensure long-term fiscal sustainability.

1/ See also Bartlett and Xhumari (2007), and ITUC-PERC (2012).

IV. CONCLUSIONS AND POLICY RECOMMENDATIONS

The early 2000s saw rapid growth, good fiscal positions, and falling government debt to GDP ratios in the Western Balkans; however, headline figures masked underlying vulnerabilities. Significant progress was made in terms of macroeconomic consolidation as general government revenue increased in most countries and gross debt was reduced across the board. However, the surge in government revenues was partly cyclical and was accompanied by increasing expenditures and discretionary tax cuts. The crisis led to a decline in revenues which, together with the difficulty in scaling back spending, resulted in a significant deterioration of fiscal positions and a build-up of debt. Changes to the composition of expenditures were also postponed during the boom years, leaving countries with rigid spending patterns and little fiscal room for maneuver.

Looking forward, the Western Balkan countries face important structural challenges as they strive to adjust to a post-boom environment. Efforts aimed at containing deficits and debt levels are also needed in light of aging populations, which over time will add to expenditure pressures. And while in some countries substantial adjustment has already taken place, additional consolidation would be needed to achieve further deficit reduction. Crucially, fiscal consolidation should be complemented by compositional changes, reducing in particular the share of current expenditures. Controls in the broader public sector should also be improved as off-budget operations and the legacy of social and subsidy spending continue to complicate budget planning in several Western Balkans countries. In most countries revenue measures should be seen as a complement to adjustment on the expenditure side.

	Challenges	Policy recommendations
Albania	high debt and financing needs, heavily dependent on banks	fiscal consolidation largely through revenue measures and phasing out energy subsidies
Bosnia and Herzegovina	balance the need for further fiscal consolidation with supporting growth; composition of spending	contain current, non-disaster related spending, notably wages and benefits; improve the quality and targeting of public spending; continue on-going efforts to improve revenue collection and administration
Croatia	high fiscal deficits, rapidly increasing public debt and elevated risk spreads	emphasis on revenue measures in near term in view of already fragile growth; gradual switch to expenditure consolidation in subsequent years
Kosovo	safeguard fiscal sustainability, arrest the worsening composition of the budget	wage and benefit moderation; improve tax compliance; shift tax policy gradually towards domestically collected taxes
Macedonia	rebuild buffers and safeguard sustainability of public finances and the exchange rate peg	fiscal consolidation embedded in a comprehensive spending review
Montenegro	high and rising debt, preserving market access	fundamental expenditure reform, including on the pension system and public sector wages
Serbia	high debt, increasing debt dynamics	ambitious and sustained fiscal adjustment through curtailing mandatory spending (wages and pensions), reducing state aid to weak SOEs

Fiscal rules can help contain spending pressures during good times and a medium-term strategy would facilitate the planning of large investment projects. Empirical studies suggest that fiscal rules have been generally associated with improved fiscal performance (IMF 2009), though of course they are only successful if there is sufficient political commitment to them. While some countries in the region have recently adopted fiscal rules (Croatia, Kosovo, Montenegro and Serbia—see Table A.2), enforcement is weak in some of these countries. It should be acknowledged that running large surpluses during boom times may be politically difficult, in particular in catching-up economies, with large demands for improvements in infrastructure.

Fixed exchange rates and a high dependence on external financing make fiscal consolidation even more crucial. Fiscal consolidation and fiscal buffers are particularly important in the context of unilaterally euroized economies (Montenegro, Kosovo), currency boards (Bosnia and Herzegovina) and exchange rate pegs (Croatia, FYR Macedonia). The prospect of tighter global financing conditions ahead could increase vulnerabilities in countries with a high reliance on external financing.

Annex. Fiscal Policies and Fiscal Frameworks in the Western Balkans

Table A.1. Fiscal positions

	avg GDP growth		Primary balance			Debt		
	2002- 2008	2009- 2013	2002	2008	2013	2002	2008	2013
WB	4.9	0.7	-2.9	-2.3	-4.1	55.2	33.0	49.9
CEE	5.1	0.0	-4.4	-2.0	-4.5	39.9	32.5	52.8
Baltics	7.0	-0.1	-1.4	-4.6	-1.3	13.8	12.4	27.6
EU-15	2.3	-0.6	-1.3	-1.7	-3.2	58.1	59.6	88.6

Table A.2. Main Fiscal Policy Measures

	Period	Revenue measures	Expenditure measures
ALB	boom years	measures to improve compliance (2000); new road tax to help finance road construction (2002); SSC rate cut (2006); tax reform lowering CIT (2007-2008)	infrastructure investment (early 2000s); spending contained to meet program targets (2003–04)
	crisis & aftermath	SSC rate cut (2009)	fiscal stimulus to soften effect of crisis, large infrastructure project (2008–09), strong fiscal relaxation prior to elections (2009); fiscal slippage and accumulation of arrears (2013)
BIH	boom years	tax system harmonization and simplification (2000-2001); VAT introduced to replace dual rate sales tax (2006)	fiscal consolidation: scale-back of pension entitlements (2001); cuts to investment and operations and maintenance spending as disappointing revenues and slow progress on demobilization required offsetting adjustments (2004–05); elections fuelled spending pressures (2006); sizeable fiscal impulse, sharp increases in transfers to households, capital spending and a 10% wage increase, fiscal policy became procyclical (2007–08)
	crisis & aftermath	administrative measures to improve tax collection (2013)	fiscal consolidation dictated by lack of foreign financing, reduction in spending on wages and war-related benefits as a share of GDP, underexecution of capital budget (2010–11); significant compression in non-priority spending due to revenue shortfalls and delays in official foreign financing (2013); new privileged pension law in the Federation, benefits of existing beneficiaries reduced (2013); registration of farmers to broaden collection base for SSC in RS (2013)
HRV	boom years	higher income tax deduction, SSC cut by 2 ppts, new VAT exemption, tax holidays and employment subsidies for new employment projects (2000), PIT average rate lowered, introduced dividend income taxation, CIT nominal rate lowered, increased depreciation allowances, but abolished the deduction for the imputed cost of equity (2001)	large wage increases (1999); cut in top salaries and 5% cut in basic wage in budgetary sphere, cuts in discretionary spending (2000); reforms in public administration and social transfers, but launch of ambitious highway project (2001); sharp reversal of fiscal policy in run-up to elections, increased highway spending, large off-budget fiscal operations (Development Bank loans for housing reconstruction; Croatian Railways) (2003); significant fiscal adjustment under SBA: continued pension reform, wage moderation, investment cuts, DB scaled back its (quasi-fiscal) activity (2004–06)
	crisis & aftermath	VAT rate hike, temporary solidarity tax (2009); VAT increase of 2 ppts, only partly offset by a 2ppts cut in health insurance contributions; some personal tax relief paid for by introduction of a 12 percent tax on dividends and profit distribution (2012)	cash spending reduced, mainly on goods and services as revenues underperformed, but arrears increased (2008), expenditure cuts, wage and pension freeze to offset plunging revenues (2009); significant consolidation: cuts in wage bill, subsidies, health spending (2012)

Table A.2. Main Fiscal Policy Measures (concluded)

UVK	boom years	limited administrative capacity, narrow coverage of domestic tax instruments, inability to issue debt (2000s)	limited revenues constrained potential for fiscal expansion (2000s)
	crisis & aftermath		capital spending main driver of increasing expenditures (2008-), public sector wage increase, increase in benefits for war invalids and their families (2011), adjustment: expenditure-saving structural reforms, notably in energy sector (2011–13)
MKD	boom years	tax cuts, emergency tax on financial transactions for 6 months (2001), CIT hike, improved tax administration (2006-2008)	additional spending on security operations, public investment program (2001); election-fuelled spending (2002); spending increased, especially on investment, and pensions and public sector wage increases (2007-2008)
	crisis & aftermath		spending cuts (2009), wage freeze (2010–11), spending reduced in line with revenue shortfalls, especially on investment and goods and services, but capital spending increased (2011), cuts to capital expenditure to offset weaker revenues (2012), some capital expenditure shifting off-budget (2013)
MNE	boom years	PIT rate cut (2007); SSC rate cut (2008)	large increase in expenditures: 30 percent hike in public sector wages, increased transfers, capital expenditure and net lending (2008)
	crisis & aftermath	increase in excises and social contributions (2010); VAT rate hike from 17 to 19 percent, additional PIT bracket (2013)	large cuts in capital expenditure, goods and services and wage bill (2009), capital expenditure cuts (2010), pension reform (2011); cuts in capital spending and transfers (2012)
SRB	boom years	simplification of tax system, reduction in number of taxes, widening of tax base, lowering of tax rates, curtailment of tax evasion (2000)	compression of spending in response to delays in foreign financing and privatization proceeds, wage bill constant in real terms (2000); large real wage increases in public sector (2002–03), tight wage policy in public enterprises and harder budget constraints in SOEs (2004); expansionary fiscal and wage policies, National Investment Plan, extraordinary repayment of pension arrears (2005–07)
	crisis & aftermath	supplementary budget with consolidation measures: increases in VAT, CIT, PIT, excise duties, non-tax revenues (2012)	spending restrained through nominal freezes on public wages and pensions, cuts in capital spending (2008); pension reform (2010); election-related expenditure overruns, recapitalization of state-owned banks, new fiscal decentralization law (2012); wage and pension indexation reduced (end 2012, 2013)

Figure A.1: Revenues and HP filtered revenues (% of GDP)

Source: World Economic Outlook and staff calculations.

Figure A.2 Changes in the composition of expenditures

Source: World Economic Outlook.
 Note: Some country-years excluded due to missing data.

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