WP/12/113

IMF Working Paper

Fiscal Consolidation in Southeastern European Countries: The Role of Budget Institutions

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INTERNATIONAL MONETARY FUND

 WP/12/113

IMF Working Paper

Fiscal Affairs Department

Fiscal Consolidation in Southeastern European Countries: The Role of Budget Institutions

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Authorized for distribution by Marco Cangiano

May 2012

Abstract

This paper assesses the relative strengths and weaknesses of fiscal institutions in ten Southeastern European countries, using recent benchmarking methodologies developed by FAD. The assessment evaluates each country's understanding of the scale of the fiscal adjustment challenge, its ability to develop a credible consolidation strategy, and its capacity to implement the strategy. Key institutional arrangements, are generally in place, including top-down budgeting and medium-term budget frameworks. Other institutional arrangements require further attention, including macro-fiscal forecasting, fiscal risk analysis, setting fiscal objectives, presence and role of independent fiscal agencies, and top-down parliamentary approval.

JEL Classification Numbers: H60, H61, H68

Keywords: Southeastern Europe, Fiscal Consolidation, Budget Institutions

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[1] This paper builds on a 2010 work by Guilhem Blondy, Richard Hughes, Ian Lienert, and Goesta Ljungman which presented the findings from a cross-country review of budget institutions across G-20 countries, a project coordinated by Marco Cangiano and Michel Lazare. An earlier version of this paper was presented at a European Commission DG ECFIN Workshop on "Public Finances in Times of Severe Economic Stress-The Role of Institutions" on November 30, 2011.

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EXECUTIVE SUMMARY

Fiscal policy-making and the institutions that support it in the ten Southeastern European countries surveyed in this paper[2] have been severely tested during the current global financial crisis. From an initial emphasis on stabilizing financial markets, stimulating economic activity, and stemming the rise in unemployment, the focus of fiscal policy has now turned to the challenges of consolidating public finances and restoring long-term sustainability. The theoretical and empirical literature both suggest that well-designed and efficiently managed budget institutions can play a central role in the success of fiscal consolidations.

This paper identifies ten fiscal institutions that can support the fiscal consolidation process at three key stages: (i) understanding the scale and scope of the fiscal challenge; (ii) developing a credible consolidation strategy; and (iii) implementing that strategy through the budget process.[3] The paper then evaluates the institutional preparedness of Southeastern European countries to respond to fiscal challenges and identifies priorities for institutional reform.

Individual countries show great variations in terms of the strength of the ten institutions. This within-country variation is greater than the overall variation across countries. Hence, there is room for improvement in all countries. The analysis presented in the paper highlights the priorities for institutional reform to support the fiscal consolidation required in the ten countries.

Improvements in the breadth, depth, and timeliness of fiscal reporting and more systematic analysis of the risks surrounding fiscal forecasts would contribute to better *understanding of the scale and scope of the fiscal challenges*. While basic fiscal reporting is in place in virtually all Southeastern European countries, less than complete coverage of institutions and transactions, and long reporting lags reduce its impact on policy-making in many countries. Multi-year macroeconomic and fiscal forecasts are the norm but tend to be limited to a single scenario. Although fiscal risks are increasingly being disclosed, quantification and control are typically limited to explicit guarantees and tend to ignore implicit guarantees and contingent liabilities.

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[2] Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Kosovo, Macedonia FYR, Moldova, Montenegro, Romania, and Serbia.

[3] The expression "fiscal institutions" refers to the organizational and procedural arrangements through which decisions on fiscal matters are taken, or which provide input into such decision-making. In the context of this paper, the ten fiscal institutions are: I. Understanding the scale and scope of the fiscal challenge – (i) fiscal reporting, (ii) macroeconomic and fiscal forecasting, (iii) fiscal risk disclosure and management; II. Developing a credible fiscal consolidation strategy – (iv) medium-term fiscal objectives, (v) medium-term budget frameworks, (vi) independent fiscal agencies, (vii) performance orientation; III. Implementing the consolidation strategy – (viii) top-down budgeting, (ix) parliamentary budget approval, and (x) budget execution.

Consolidation planning needs to be supported by more clearly articulated fiscal objectives, more comprehensive and binding medium-term budget frameworks, greater independent scrutiny, and a stronger focus on performance. While most Southeastern European countries set medium-term objectives for fiscal policy, these are not often formulated and monitored in a manner which enables the public to hold the government to account for their realization. Medium-term budget frameworks are in place in nearly all countries but need to be expanded in coverage and impose more binding constraints on future budgets. Independent fiscal agencies providing input into fiscal policy-making remain uncommon in Southeastern Europe. While all Southeastern European countries have introduced elements of performance budgeting, performance information needs to be more systematically integrated into budget decision-making processes in most countries.

Finally, *implementation* of *consolidation plans* would benefit from a more rigorous top-down approach to budgeting, stronger parliamentary endorsement of consolidation strategies, and more explicit contingency arrangements. Budget preparation follows a top-down approach in most Southeastern European countries to a degree, but budgetary rigidities and circumvention of the budget process diminish its disciplining impact. Parliamentary ownership of the government's fiscal strategy is limited by a traditional bottom-up, chapter-by-chapter approach to budget approval in most countries. While controls over budget execution are relatively strong, management of contingency reserves and controls on multi-year spending commitments need to be strengthened in order to keep consolidation plans on track.

I. INTRODUCTION

1. **As in most countries, the economies and public finances of Southeastern Europe (SEE) have been affected by the global economic crises.** Looking ahead, medium-term fiscal policy in all countries needs to focus on ensuring fiscal sustainability, bearing in mind the fragile nature of the economic recovery and the need to implement key structural reforms to address longer-term fiscal challenges, such as demographic changes and increasing age-related expenditures.

2. **This paper identifies budgetary institutions that can support fiscal consolidation, and assesses the institutional preparedness of Southeastern European countries for the fiscal challenges ahead**.[4,5] Restoring stability and sustainability to public finances will be a priority in coming years in many Southeastern European countries, and there is evidence that certain *institutional arrangements* can greatly enhance fiscal rigor. This suggests that governments should also, as part of the consolidation strategy, consider the adequacy of the structures, rules and procedures that govern the formulation, passage, and execution of their budgets. Reforms in institutional framework can not only improve fiscal discipline in general but also increase the probability of successful consolidation.

3. **The paper reviews ten budgetary institutions that can support Southeastern European countries' consolidation efforts at three key stages of the fiscal policy-making process:** (i) understanding the scale and scope of the fiscal challenge; (ii) developing a credible fiscal consolidation strategy; and (ii) implementing that strategy through the budget process. The paper goes on to provide an evaluation of the Southeastern European countries' institutional preparedness for fiscal consolidation. It then concludes with a set of recommendations about the key institutional reforms that could increase the changes of successful fiscal consolidations in the Southeastern European region.

4. **The paper is structured as follows.** Section II provides the rationale for the study. Section III identifies key budgetary institutions supporting fiscal consolidation. Section IV summarizes the findings of an assessment of Southeastern European countries against this framework. Finally, Section V discusses priorities for institutional reforms. Appendix I presents the full institutional framework.

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[4] The study draws from a series of papers prepared by IMF staff on the impact of, response to, and exit from the current economic, financial, and fiscal crisis. See, for example, IMF (2009a), Cottarelli and Viñals (2009), IMF (2010a, 2011a, 2011b).

[5] The factual information underpinning these country evaluations was validated with participants at an FAD fiscal institutions seminar for Southeastern European countries held in Ljubljana, Slovenia in June 2011. The results should nevertheless be treated as provisional until officially confirmed with country authorities.