Fiscal Rules and Fiscal Councils
Lessons Learned and Applications for Macedonia

Marjan Nikolov

No. 2018-05, April 2018

CEPS Papers in Liberty and Security in Europe offer the views and critical reflections of CEPS researchers and external collaborators on key policy discussions surrounding the construction of the EU’s Area of Freedom, Security and Justice. The series encompasses policy-oriented and interdisciplinary academic studies and comment on the implications of Justice and Home Affairs policies within Europe and elsewhere in the world.

This publication has been carried out within the framework of the ENGAGE Fellowship Programme. The Fellowship Programme counts with the support of the Open Society Initiative for Europe (OSIFE). It is a tailor-made Programme that connects academic, civil society and think tank actors from Central and Eastern European and Western Balkans countries with EU-level policy debates. It consists of a one-year programme providing a set of trainings, study visits, public events and a policy brief writing exercise. The ENGAGE Fellowship takes a Rule of Law approach to the policy domains of Rights, Security and Economics. See the penultimate page for a description of the ENGAGE project.

The Programme is coordinated by the CEPS Justice and Home Affairs Unit and counts with the involvement of several CEPS Senior Research Fellows. This publication has been supervised by Cinzia Alcidi, Head of CEPS Economic Policy Unit.

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Key points for policymakers

In 2008, unlike Croatia and Albania, Macedonia was not invited to become a NATO member owing to its name dispute with Greece – a dispute that also complicates its accession to the EU. The disappointment felt in Macedonia at this rejection was immense: the government’s rhetoric became more nationalistic and populist. The government moved towards debt-driven growth policies and growing deficit spending. The new policies were accompanied by lack of fiscal transparency and an increased appetite for clientelistic forms of governance. The rule of law, fiscal transparency, accountability and controlling corruption all eroded dramatically, leading to an increased level of state capture by the incumbent political party and to unsustainable public finances. In 2016, Freedom House reported that Macedonia was only a partially free country. Macedonia’s political elites have since proposed fiscal rules and a fiscal council to facilitate more sustainable public finances.

Policy recommendations

The creation of an independent national fiscal institution can enhance fiscal transparency and contribute to improve sustainability of public finances as long as it is well-designed, it builds on political consensus and its operations enjoy the support of citizens. A fiscal council must have an explicit statutory role to monitor fiscal policy, which should be based on explicit fiscal rules. In order to be able to exert positive pressure on policy makers towards more transparency and sound policies, it must also have access to relevant information and visibility in public debate. These are the necessary factors for a credible fiscal council in Macedonia.

Background

Good governance depends on the rule of law, accountability and controlling corruption, but the necessary condition for these is transparency. In public finance management, the erosion of fiscal transparency and discretionary policies can lead to unexpected increases in debt, with ensuing financial and economic consequences for taxpayers and society as a whole. In the Macedonian context, public debt tripled during 2008-16 and tax revenues as a share of public debt decreased from 80% in 2008 to 34% in 2016, as illustrated in Figure 1.
These figures are the result of both domestic and external factors. External factors materialised as a combination of the global financial crisis and the NATO’s decision to not extend an invitation to Macedonia to become a NATO member. In particular, while Croatia and Albania were invited to join NATO in the occasion of the “2008 Bucharest Summit or 20th NATO Summit”, Macedonia was not, even though NATO officials recognised that Macedonia was ready to join. Such decision was due to Macedonia’s dispute with Greece over its name – a dispute that also complicates its accession to the EU (NATO, 2008). The disappointment was immense and this set the stage for a new government’s rhetoric, more nationalist and populist. Such an approach seemed to gain leverage in 2011, when the international Court of Justice ruling that Greece was wrong to block Macedonia’s bid for NATO membership did not persuade NATO or the EU to change their decisions on Macedonia’s membership.

The domestic factors were, to a large extent, triggered by the external ones in form of policy responses and resulted in a change of fiscal paradigm, which soon degenerated in erosion of fiscal discipline and abuse of executive power to the point where the ruling party’s style of governance has been labelled “state capture” (European Commission, 2015).

As of 2006, the new government introduced a number of supply-side policy measures (immediately after the elections, when the right-wing VMRO DPMNE\(^1\) coalition took power, replacing the left-wing SDSM-led\(^2\) government coalition), aiming to reduce the tax burden and improve the business environment. The so-called ‘flat tax’, according to which personal income and corporate profits would be taxed at one marginal rate (12% in 2007 and 10% in and after 2008) was introduced, together with the gross wages system, in expectation of higher domestic investments. Desperate for foreign direct investment (FDI) inflows and burdened with high unemployment, the government decided to promote a “cheap workforce”, thus focusing more on narrow pricing-measures to attract FDI instead of working on good governance measures.

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\(^1\) The Internal Macedonian Revolutionary Organization – Democratic Party for Macedonian National Unity.

\(^2\) Social Democratic Union of Macedonia.
(rule of law, transparency and accountability improvements) in a broader effort to attract FDI (CEA, 2016a).

Once the global financial crisis hit, the government embarked on countercyclical fiscal policy. Following the unprecedentedly high fiscal spending in the last quarter of 2008, which created a fourth-quarter budget deficit of 3.6%, the government continued with high spending in the first quarter of 2009, creating a fiscal deficit of 0.5%. Despite expectations that the government would increase capital expenditures that were meant to boost economic growth, they instead decreased by 1% while current expenditures rose by 17% in the first quarter (year-over-year) (Nikolov, 2016). Capital expenditure was planned to grow by 46% in 2009 relative to 2008 to compensate for the expected fall in private investments and lower external demand. Yet the weak implementation of the planned capital expenditures turned out to be the main obstacle to the timely execution of publicly funded projects. Current expenditures were dominated by non-discretionary spending (salaries, pensions, social assistance and agricultural subsidies) and transfers substantially increased in 2007-08, as illustrated in Figure 2a and Figure 2b.

Figure 2a. Transfers and pensions as a percentage of total expenditures in Macedonia, 2006-16

![Transfers as % of total expenditures](image1)

![Pensions as % of total expenditures](image2)

Source: Author’s calculations based on Ministry of Finance data.

Figure 2b. Social transfers and agriculture subsidies in Macedonia, 2006-16 (€ millions)

![Social transfers in € millions](image3)

![Agriculture subsidies in € millions](image4)

Source: Author’s calculations based on Ministry of Finance data.

Fearing it could lose power owing to its mishandling of the financial crisis and its failure to gain entry into NATO and the EU, the right-wing VMRO DPMNE coalition government repeatedly pursued clientelistic electoral strategies, started the practice of budget deficit bias and debt-
driven growth. Figure 3 illustrates the government’s deficit bias. The bold line is the actual budget balance and the short lines are the planned budget balances as per the government’s economic reform programmes.

*Figure 3. Deficit bias in Macedonia as a percentage of the GDP in Macedonia*

Furthermore, the political wiretapping scandal resulted in Macedonia being judged a partially free country by Freedom House (2016), which stated: “VMRO-DPMNE broadly undermined democracy and rule of law in 2016, leading the European Commission to dub the ruling party’s style of governance ‘state capture’ in the EC progress report for Macedonia.”

**Erosion of fiscal discipline and the rule of law**

The government routinely exceeded its budget: fiscal data show budget expenditures and consequent budget deficits increased considerably prior to elections (CEA, 2016b). Also, capital expenditures significantly intensified prior to and during each election cycle, followed by stabilisation and a slight decrease. Social transfers increased significantly prior to and during the 2011, 2013 and 2014 elections (CEA, 2016b).

Fiscal transparency and accountability are declining and are at lower levels compared to EU countries (Nikolov et al., 2015). Also, given the Freedom House ranking, Macedonia is at risk of becoming a fragile state (Freedom House, 2016). The rule of law has also eroded quickly, particularly since 2014. As Freedom House stated, “Macedonia’s ruling party at that time was implicated in electoral fraud and an expansive wiretapping scandal, exacerbating a bitter political standoff with the opposition that ultimately required the EU to step in and broker snap elections for 2016” (Freedom House, 2016). The wiretapping scandal was first revealed by the opposition on 9 February 2015. The European Commission (DG Neighbourhood Policy and Enlargement Negotiations) recruited a group of independent senior rule of law experts to carry out a rapid analysis of the wiretapping and related systemic problems provided

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recommendations to address them (European Union, 2015). In their 2015 report, the experts stated, among other things, that the wiretapping materials published by the opposition demonstrated serious incidents of political corruption, emphasising that press freedom is an essential basis for an open, democratic society and that transparency in general should prevail as an indispensable method for dealing with crisis situations such as the wiretapping scandal.

As argued thus far, the decline of the rule of law, derogation of parliamentary democracy, the lack of respect for a clear separation of powers, lax fiscal discipline and eroding fiscal transparency all began before the 2015 wiretapping scandal. Three concrete developments within the country substantiate this statement: the erosion of fiscal transparency, creative accounting episodes and disrespect for the Constitution and clear separation of powers.

For the fiscal transparency example, according to the 2015 Open Budget Index (OBI) calculated annually by the International Budget Partnership, Macedonia was among a group of countries that provide “minimal information” about their budget processes, with an index value of 35, which ranked the country 68th out of 100 countries surveyed. Back in 2008, Macedonia had been among a group of countries that provided “some information” about their budget processes, with an index value of 54. Thus, a clear erosion of fiscal discipline and transparency has taken place, as illustrated in Figure 4.

Figure 4. Open Budget Index for Macedonia (left hand side) and (OBI Score ranges (right hand side)

<table>
<thead>
<tr>
<th>OBI Score ranges</th>
<th>OBI Score ranges</th>
</tr>
</thead>
<tbody>
<tr>
<td>Extensive information</td>
<td>(OBI Scores 81-100)</td>
</tr>
<tr>
<td>Significant</td>
<td>(OBI Scores 61-80)</td>
</tr>
<tr>
<td>Some</td>
<td>(OBI Scores 41-60)</td>
</tr>
<tr>
<td>Minimal</td>
<td>(OBI Scores 21-40)</td>
</tr>
<tr>
<td>Scant or No information</td>
<td>(OBI Scores 0-20)</td>
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Regarding creative accounting episodes, the Ministry of Finance, under pressure from public and international financial institutions concerning the unsustainable increase in public debt, changed the definition of public debt so as to exclude the Central Bank’s debt. At the same time, the Ministry publicly presented the official state debt, which excluded the guaranteed debt of public enterprises. Public and independent think tanks increased pressure on the Ministry concerning these creative accounting episodes, particular when, in March 2014, voting records of multilateral development banks (MDB) revealed that the World Bank had abstained.

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4 See more at OBI’s website: www.internationalbudget.org/budget-work-by-country/findgroup/group-data/?country=mk.
from voting on the Second Programmatic Competitiveness Development Policy Loan to Macedonia because of “[i]nadequate budget transparency and public financial management”. Also, in anticipation of additional public debt generation owing to road construction, the Macedonian Agency for State Roads was re-established as the Public Enterprise for State Roads in order to place its debt off-budget. Debrun & Kumar (2012) argue that “such practices [creative accounting] undermine credibility of the public sector, with corrosive effects on trust and accountability in the public domain”. Thus, the absence of social consensus on fiscal discipline, inadequate budget transparency and creative accounting increased the risk that an institution such as a fiscal council would be ignored or discredited. In that sense, a fiscal council – intended as independent fiscal institution - could easily end up being used as a smokescreen.

Finally, regarding disrespect for the Constitutional separation of powers, in December 2012, the executive branch forcefully removed opposition MPs as well as journalists from the parliament chamber in anticipation of the 2013 budget debate. This constituted not only derogation of fiscal transparency by the executive branch but also a clear attack on the Constitution and the rule of law. Constitutional rules for separating executive and legislative powers and maintaining checks and balances were forcefully neutralised.

Can a fiscal council improve fiscal transparency and meet rule of law challenges in Macedonia?

The economic literature investigated the issue of whether independent fiscal institutions can contribute to improve fiscal transparency and fiscal discipline. For instance Debrun & Kumar (2012) test the hypothesis that fiscal councils are effective commitment devices, but also the reverse causality, i.e. the hypothesis that commitment comes first and well-behaved governments introduce a fiscal council to reveal their preferences to the public. They find empirical evidence supporting both hypotheses. Based on such findings that fiscal councils can work as commitment devices, the question is whether, in Macedonia where good governance and the rule of law have eroded, a fiscal council can deliver good outcomes. Since the risk that a fiscal council is labelled partisan, thus undermining its credibility and trustworthiness, always exists, political consensus for introducing a fiscal council is paramount to restoring public finances to a sustainable path and maintaining fiscal discipline.

For Macedonia’s 2011 elections, the ruling coalition’s election programme proposed introducing fiscal rules, and the opposition’s election programme proposed introducing a fiscal council. Both proposals reflected implicit consensus and indirect recognition by political elites that public finances had been on an unsustainable path since 2008, as already explained above.

Given both proposals, political consensus is expected in support of a public finance framework with more transparent procedures and rules that will regulate the budget process and, in a non-partisan, independent and credible fashion, reduce asymmetric information between the executive branch, the public and the parliament. It is expected that well-established procedures, rules and transparency will reduce the possibility of further discretionary fiscal policies (Debrun & Kumar, 2012). Even though fiscal rules are not a necessary prerequisite for the introduction of a fiscal council, introducing explicit fiscal rules in the fiscal council’s mandate
would make the council more effective and might, by making its mandate more focused, promote stronger fiscal discipline (IMF, 2013a).

A fiscal council can promote stronger fiscal discipline as long as it is well-designed, plays an explicit role in monitoring fiscal policy rules, and exerts a strong presence in the public debate, as argued by the IMF (2013a). Thus, political elites in Macedonia should: i) build consensus around a well-designed fiscal council that ii) rely on explicit fiscal rules and iii) develop an effective communications strategy.

Regarding political support, on the one hand, in realms where Macedonia faces many challenges (fiscal policy, health, education, poverty and unemployment), some consensus is emerging and solutions proposed by all of the parliamentary parties are more or less similar, i.e. they cluster around the “median voter”. But these challenges are not only many; they are also the greatest that Macedonia has faced in more than 26 years of independence. On the other hand, in areas where consensus is lacking (balance of payments and monetary policy), Macedonia experiences the most success (CEA, 2012). This clearly illustrates a need for vision and action apart from the daily political rhetoric by political elites. Giving speeches or even writing a legislation is not enough to ensure effective implementation of policies, more fiscal transparency, fiscal discipline and accountability. A deeper political consensus, expression of the will of the citizens, is a *conditio sine qua non* for escaping this rhetoric and providing more credibility to a fiscal council.

The importance of political consensus is best illustrated by the Hungarian Fiscal Council. In the 2007 Hungarian elections, improving public finances and fiscal policy was high on the political agenda, and in November 2008 a new law on fiscal responsibility established the Hungarian Fiscal Council with a mandate to help restore the sustainability of fiscal policy and promote fiscal transparency. The law had failed to gain the support of the main opposition party, so when it came to power the Fiscal Council, though not abolished, was weakened and its framework and working conditions were significantly revised (IMF, 2013b). Moreover, the Fiscal Council was reduced to a part-time body with no specific responsibilities in applying fiscal transparency and sustainability (Kopits, 2011).

The Hungarian case illustrates that in highly polarised political landscapes, such as Macedonia, maintaining independence and building institutional credibility are more difficult. On a technical level, a fiscal council should have an explicit statutory role and mission in monitoring fiscal policy that should be based on explicit fiscal rules, and it must have a strong presence in the public debate, because in a parliamentary democracy it is public pressure that drives the accountability of politicians. Thus, political consensus, clear fiscal rules and free press are key factors for the success of a Macedonian fiscal council, and its success can make the rule of law, fiscal transparency and accountability endogenous.

Finally yet importantly, a fiscal council usually has an advisory role with an aim to control the government’s overoptimistic forecasts and short-term deficit bias. For example, delegating macroeconomic forecasts to a fiscal council can reduce forecasting bias (Hagemann, 2011). Depending on the size and capacity, fiscal councils can produce their own forecasts to contrast
them to the official ones. In absence of such capacity, they can still exert pressure by leveraging on their power to endorse/reject the government’s forecasts. Macroeconomic forecasting requires control as well. For example, the Macedonian government routinely overestimated budget revenues and expenditures. Our calculations illustrate that average annual overestimation (IMF, 2016: 6, 20)5 of 2009-15 planned revenues was around 7%6 and that of 2009-15 planned expenditures was around 6%.7

**Conclusions and policy recommendations**

A fiscal council could enhance public scrutiny of policies through greater demand for transparency, information and expert advice, and it could shift the focus to the long-term consequences of policies, thus halting the cycle of vying for political short-term gain. In this way, budget deficit bias, consistency of policies and, consequently, debt increases might become more politically onerous (Debrun & Kumar, 2012). Introducing a fiscal council in a partially free country whose governance, rule of law and fiscal transparency have eroded could put a stop to distorted incentives of *ad hoc* fiscal policies. It could also reshape policy-makers’ incentives to ensure that fiscal policy remains consistent with intertemporal budget constraints and macroeconomic stabilisation.

A fiscal council can promote stronger fiscal discipline in Macedonia as long as its creation enjoys large political support and it is well-designed. Well-designed means, it must have an explicit statutory role in monitoring fiscal policy based on explicit fiscal rules. Second, it must gain space in the public debate. This requires a good communication strategy but, above all, free press. The latter is key to a fiscal council’s success, because it is through the media that information flows to the public and the demand for more political accountability increases. This is particularly relevant in Macedonia where the value of accountability is limited and the statutory role of a fiscal council should be focused on the transparency function, on supporting policy maker and on enhancing public scrutiny of policies.

Lastly, the effectiveness of a fiscal council can be fostered through adopting and implementing of proper legislation, by clearly spelling out the council’s procedural and transparency requirements and regulating access to relevant information. In addition, a clear and legally stated “comply or explain” rule applied to the government (Jankovics & Sherwood, 2017) would strengthen the council’s legal standing. This rule would oblige the government to respond to the fiscal council position publicly and within the deadlines prescribed in the legislation.

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5 “The authorities are yet to implement key recommendations of the last two Article IV consultations:…improve budget planning and medium-term budgetary framework, and adopt durable revenue and expenditure measures to support fiscal consolidation” (p. 6). Also: “…Institutional readiness needs improvement given limited linkages between the medium-term budget framework and the annual budget process, persistent over-projection of revenues and the periodic build-up of public sector payment arrears” (p. 20).

6 Planned revenues as per the executive budget proposal compared with actual revenues as per the final account.

7 Planned expenditures as per the executive budget proposal compared with actual expenditures as per the final account.
References


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CEPS launched the ENGAGE Fellowship Programme with the support of the Open Society Initiative for Europe (OSIFE). This tailor-made Programme connects academic, civil society and think tank actors from Central and Eastern European and Western Balkans countries with EU-level policy debates. It consists of a one-year programme providing a set of trainings, study visits, public events and a policy brief writing exercise. It culminated in the active participation of the selected fellows in the 2018 CEPS Ideas Lab.

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