Economic Horizons, May - August 2012, Volume 14, Number 2, 91 - 100
UDC: 33 eISSN 2217-9232

Review paper
UDC: 336.02(4-12) ; 336.143(4-12)
doi: 10.5937/ekonhor1202089J

INSTITUTIONAL AND POLITICAL FACTORS OF FISCAL CONSOLIDATION

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The financial crisis in several European countries has turned into a full blown sovereign debt crisis. The current trends of public debt burdens per capita could be averted, but not by relying primarily on economic growth, for which the outlook is bleak in the near term. The best approach to solving the crisis is not through growth, but through a serious – and undoubtedly painful – process of fiscal consolidation to reduce government deficits and debts accumulation. After the short consideration of the recent fiscal and debt positions of six South-Eastern European (SEE) countries, placing an emphasis on the Republic of Serbia, the paper analyzes which institutional and political factors can lend credibility to consolidation efforts and underpin the commitment to financial sustainability.

Keywords: fiscal consolidation, credibility, rules, institutions, SEE countries

JEL Classification: G01, H62, H63, H68, P52

INTRODUCTION

The financial crisis in several countries in Europe has turned into an open crisis of sovereign debts. In late 2010, The Bank for International Settlements published that, in the worst case scenario, the burden of the public debt per capita for the working–age population in Great Britain and France could grow to 900,000 EUR by 2040. This score is assumed if the governments of these countries do nothing to reduce the existing levels of debts and structural deficits, and expenditures for the elderly continue the current trends.

This scenario can be changed, however not by relying primarily on economic growth as the outlook for the near future is bleak. In the second half of 2011, international and national institutions revised downward GDP growth rates in a large number of European countries two to three times. The best way to resolve the crisis is not through growth, but through a series of serious and painful processes of fiscal consolidation that will reduce government deficits and debts accumulation.

The first part of the paper explains why it is necessary for Serbia to bring a sustainable and credible fiscal consolidation program and which requirements should be met in that case. The second part analyzes to what extent and under what conditions institutional arrangements and tools (fiscal rules, fiscal councils,

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the medium term budget framework and budgetary procedures) are able to provide strong support for fiscal consolidation. The final part gives a comparative view of the degree of the development of institutional arrangements in the SEE countries.

THE NECESSITY OF A CREDIBLE FISCAL CONSOLIDATION

In 2011 and at the beginning of 2012, in all SEE countries, Non-Members of the EU (Serbia, B & H, Montenegro, Croatia, Macedonia and Albania), particularly in Serbia, a poor fiscal situation and the continued debts accumulation (Table 1) could be noticed. Although the slow growth was to blame, tensions in the debt market increasingly strangled the economic activity in the SEE countries. The risk of financial tensions was also spreading and increasing on the account of unresolved problems in the recession of 2008-2009.

Day by day, hour by hour, investors assess the fiscal future of each country. One useful quantitative indicator is credit – the default swap market. However, market bets are not a destiny. Political leaders and voters have a choice of how governments can reverse the course and pace of a financial collapse. Those who do plan to commit themselves to making difficult choices can the most fruitfully focus on the measures that will achieve sustainable consolidation so that their countries cannot only weather the current crisis, maybe the next one (Cottarelli, 2010; Cullis, & Jones, 1998).

The Serbian economic policy's response to a growth slowdown and a fall in inflation was generally adequate in 2011. It should be noted that the automatic fiscal stabilizers were allowed to operate; the rebalancing budget for 2011, adopted in October, kept the objectives unchanged in terms of spending, despite the lower revenues caused by a slower growth, leading to a higher deficit that was provided for the original budget. The monetary policy was also eased in the context of lower inflation pressures; the National Bank of Serbia (NBS) has lowered its repo rate by a total of 300 basis points since April, making it virtually nullify the previous tightening of the policy. After the beginning of 2011, the inflation reached the highest level of almost 15%, which was further expected to be closer to the target inflation rate of the NBS with allowed tolerance at the beginning of 2012.

The completion of the first audit of the Stand-by arrangement was postponed because the budget for 2012 was not in accordance with the agreed fiscal program. The fiscal program for 2012, upon which an agreement was reached between the IMF and the Government in November 2011, predicted the fiscal deficit target of 4.25% of the GDP and the domestic issuance of government guarantees was limited to about 1% of the GDP. However, the adopted budget for 2012 includes the additional issuance of the public debt (including the governments' guarantees) and projects financed from domestic sources amounted to almost 2% of the GDP.

Table 1 GDP growth, the fiscal balance and public debt in the SEE countries

SEE countries Non-Members of EU	GDP real change in %					Fiscal balance in % of GDP			Public debt in % of GDP		
	2009	2010	2011	2012*	2013*	2009	2010	2011	2009	2010	2011
Serbia	-3.5	1.0	1.9	0.0	1.0	-4.5	-4.6	-4.7	34.8	43.0	45.0
B & H	-2.9	0.7	2.2	0.5	1.5	-4.5	-2.5	-2.6	35.3	39.0	39.6
Macedonia	-0.9	1.8	3.5	2.3	3.0	-2.7	-2.5	-2.5	31.7	35.6	35.0
Montenegro	-5.7	2.5	2.0	1.0	2.0	-3.6	-3.0	-3.2	38.2	41.9	44.0
Croatia	-6.0	-1.2	0.3	-1.2	1.0	-3.3	-4.3	...	35.1	41.3	44.0
Albania	3.3	3.6	1.9	2.2	2.6	-7.0	-3.1	-5.0	59.7	58.2	60.0

* Revised prognoses, April 2, 2012

Source: www.wiiw.ac.at/?action=publ&id=countries&value

In the announcement of February 20, 2012, The Fiscal Council of Serbia assessed that: (1) the fiscal deficit exceeded the limit set at 4.5% of the GDP by the fiscal rule. The deficit amounted to 4.7% of the GDP. The deviation was the result of great optimism in the planning of the revenue, but not of making an increase in spending. However, the real threat to the Serbian public finances is the establishment and continuation of the unfavorable trend of the public revenue in 2012; (2) the public debt surpassed the statutory limit set at 45% of the GDP, by fiscal rule, increasing to 46.7% of the GDP. The Fiscal Council warned that the public debt would continue to grow in the medium term, even if the economy were recovered from 2013, possibly reaching 55% of the GDP if the government did not adopt the program of fiscal consolidation (The Fiscal Council of the Republic of Serbia, 2012).

In the first quarter of 2012, the general government deficit deviated from the target one by about 30 billion dinars. The planned program of the government savings (taking on from budget users their own revenues and savings on discretionary expenditures) of 15 billion are not enough, even if they are fully realized. It is obvious that the space for this kind of consolidation is rapidly reduced and that without other austerity measures and a credible program of fiscal consolidation, there is a risk that investors will quickly lose their confidence in the sustainability of the public finances in Serbia (The Fiscal Council of the Republic of Serbia, 2012).

All this indicates that the introduction of fiscal rules, the independent fiscal council and other legislative changes can give certain credibility to the government policy; however, they are not a sufficient condition. When the government has not showed a strong commitment and determination to adopt a clear program of fiscal consolidation, rules and institutions are vulnerable.

Serbia needs a credible fiscal consolidation program which would be integrated into the overall economic policy because creditors and taxpayers seek reliability in fiscal management in order to continue to finance public expenditures. Faced with a deteriorating fiscal position, Serbia should not calm the market by claims that can count on a future economic growth to help the country solve the problem.

The publication of a credible fiscal consolidation plan in a transparent manner would change the expectations of the key economic actors. That change would have a positive impact on the economic activity. With the assumption that dominates the reduction of expenditures over increasing taxes, fiscal consolidation promotes recovery with a higher probability rather than impedes it, particularly if it is assessed that there are a high deficit and high consumption. For the success of fiscal consolidation, it is important to develop not only a "defensive" consolidation strategy, but to connect it with the 'offensive' elements (the infrastructure and R&D) that can strengthen the future economic development. There is empirical evidence (Alesina & Ardagna, 1998; Acocella, 2005) that even large fiscal contractions can be expansionary because they can signal a permanent and decisive change in the fiscal policy.

The elimination of the sizable fiscal deficit in Serbia must be achieved as a "social project" rather than an usual, normal, budget exercise, in order to reconcile the fiscal capacity with demands for funding, including funding for future government priorities.

To achieve a sustainable fiscal consolidation within the stipulated time span, it should be equitable. Equity has many dimensions, including the maintaining of adequate social safety nets and the provision of public services that allow a level playing field, regardless of the conditions at birth. The struggle to reduce the tax evasion is also an important component of equity. When it comes to value added tax (resilient to fraud), the average tax evasion of 15% of revenues in developed countries and about 23% of revenues in Serbia is a sensitive issue. Evasion is higher in the cases of other taxes in all countries. Achieving equitable consolidation is also a matter of the political sustainability of the same; it is especially important if it is perceived as being imposed by international organizations. The Greek experience is enlightening in this respect. The package imposed by the troika ECB, EU and IMF was initially supported by the majority of the population, while at the end of 2011, less than 20% of the Greeks supported the reform, because they failed to tackle tax evasion, the corrupt public administration and the privileges of well-connected groups (Molnar, 2012).

The new government of Serbia is expected to pass as soon as possible a mid-term program of fiscal consolidation with the concrete measures making the results visible as soon as possible, thus reducing uncertainty. As is envisaged by the Serbian Fiscal Council, the program would be implemented over the next three or four years and would be adopted simultaneously with the rebalancing of the budget. It was estimated that the adjustment would be about 4% of the GDP, in the next four years, which should be achieved in the proportion of 3/4 on the expenditures side (the expenditure cuts by 1.23 billion Euros) and of 1/4 on the revenues side.

It is usually assessed that the newly-elected government is politically stronger; it has a legacy. It is better positioned to initiate major changes, especially if it has a clear mandate from its voters. Because they do not have to stand for re-election, imminently, fresh leaders have more opportunities to devise and implement a consolidation plan, and even have time to make mid-course corrections. The stability of a political system is also a thing that matters, because consolidation requires cooperation between different ministries, agencies and levels of government. Difficulty gaining the cooperation and support of a broad group of stakeholders, in Spain today, and in Serbia tomorrow, may reduce the ability of the government to make forward on all fronts.

Therefore, an open and inclusive approach is needed because it is ascertained that the Serbian political factors significantly affect the fiscal performance over the next chain (Figure 1).

The relatively high political fragmentation within the government (as reflected in a number of political parties and line ministries) is related to the proportional electoral system which affects fiscal outcomes (usually larger welfare programs, more spending and an overall tendency to the deficit), although the election rules may be endogenous to the degree of fragmentation within a society itself. These facts are related to in Figure 1, which gives a stylized description of the aggregation of individual preferences in fiscal performance, first through the election rules and then through decision-making in the government itself. In short, it is shown that fiscal performance depends on (1) the degree of the conflict within a society and as reflected within the government, and (2) tools or levers for resolving political conflicts, i.e. the rules under which elections are organized as well as fiscal rules and institutions governing the budget process (Besley & Case, 2003; Fabrizio & Mody, 2006; Lavigne, 2011).

DEVELOPMENT DEGREE OF INSTITUTIONS FOR CONSOLIDATION

As is shown in Figure 2 in a simplified way, the fiscal consolidation process takes place in three phases.
Realizing that wider political and institutional setting is difficult or impossible to change only for the purpose of improving the fiscal position of the country, solutions that should reduce deficits and debts are seeking to improve fiscal management in the country (Debrun, at at, 2009; Myles, 2009).

The research has shown that Serbia and other SEE countries have the basic institutional arrangements and tools which make up what is now called the national fiscal framework (numerical fiscal rules, independent fiscal institutions, the medium-term budgetary framework for the multi-annual budget planning and budgetary procedures) which influences the preparation, approval and implementation of the budget plans. However, the survey is also indicative of

Figure 1 Chain of influence of political factors on the fiscal performance

the fact that many of these institutions have remained incomplete. On the following pages, an emphasis is placed on the analysis of the institutional arrangements related to Phases II and III of the consolidation process described in Figure 2.

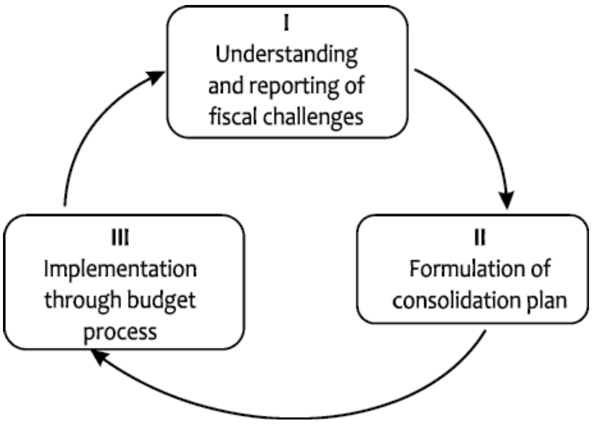

Figure 2 Phases of the consolidation process

Fiscal rules

Fiscal rules can sustain the fiscal consolidation, but may not be sufficient by their own to return the debt to the prudential level. An important justification for the adoption of a fiscal rule is related to the reluctance of governments to commit themselves to fiscal discipline and their ability to abandon the published plans before implementation. In this context, fiscal rules can help governments to commit themselves and reduce the fears of the financial markets. Copits & Symansky (1998) define a numerical fiscal rule as a permanent constraint on a fiscal policy in terms of the summary indicators of fiscal performance, such as the state budget deficit, the debt, expenses, revenues, or some of their main components.

While debt targets can provide a long term anchor for a fiscal policy, the more commonly used fiscal rules for debt ceilings are relatively impotent until they become mandatory. There is no one size fitting all approaches, if we take into account various fiscal problems and economies different in nature (Debrun, et al, 2009)

In addition to their intended direct effects, the rules also play an important role in communicating with the public, and from that standpoint, they should be relatively simple. However, as the fiscal policy is multi-dimensional and pressures on the fiscal policy change over time, a single or even a simple set of fiscal rules is unlikely to be optimal at all times. The tensions that affect the fiscal policy include respecting inter-temporal budget constraints, the long-term sustainability, achieving the short-term stability, addressing distributional issues and promoting allocative efficiency. All this demands more complex rules, which are difficult to implement and communicate, and simultaneously, because of their complexity, they may undermine accountability. Obviously, effective rules are not easy to formulate in the long-run.

Certain empirical findings (IMF, 2009) suggest that more comprehensive fiscal rules covering the larger part of the government activities and the larger number of the government levels (the general government, the local one) are more effective in debt stabilizing. However, it should be noted that evaluating the impact of numerical fiscal rules on budgetary outcomes raises a number of questions for which there is no perfect statistical answers. The main conceptual issue with significant statistical implications is related to the existence of a possibility that rules can only be a reflection of the current strong preferences for fiscal discipline. As such, numerical rules potentially suffer from the same problem of credibility as discretionary policies do. According to this reasoning, the only credible rule would be a mere description of what the government has done with pure discretion (Debrun at al, 2008). That is, the causality may also go to the other way, because those governments that are more committed to stabilizing the debt are more likely to adopt more comprehensive fiscal rules.

A rough hierarchy of the fiscal rules regarding their effectiveness to control debt dynamics can be also ascertained. Fiscal rules based on the deviation from the deficit targets and the frequent combinations of rules based on the deficit target and the debt target, have a greater effect than the rules based only on the debt. The ranking of fiscal rules is certainly caused by previous history of shocks to debts and the deficits of each individual country (Wyplosz, 2011).

The key recommendations for the effective functioning of fiscal rules are: mechanisms for the correction and enforcement of sanctions and escape clauses. The actions to be taken in the case of non-compliance should always be defined ex ante, so as to make the rule credible and enforceable. Otherwise, the cost of non-compliance would only be reputational, which is insufficient when there are acute fiscal disorder and weak budgetary institutions, as it is the case in Serbia now. The enforcement of the corrective measures should be ensured by non-partisan institutions (with appropriate competencies) and also legally secured. It is desirable that monitoring and enforcement be carried out by the same independent body. In the case of non-compliance with the rule, the predetermined sanctions can supplement the enforcement mechanisms. They can be applied to the institutions and can be in the form of fines, automatic withholdings of transfers, restrictions on issuing a debt, or personal sanctions including dismissal procedures, obligations to resign and penalties in the form of lower salaries (EC, Public Finance, 2010).

Clearly defined escape clauses are an important feature of good fiscal rules. They define the circumstances under which departures from the rule are admissible: usually, these include natural disasters or acute economic recessions; such clauses refer to a limited number of circumstances. Precise escape clauses may increase credibility, while the vague and non-concrete ones can make a rule ineffective.

Fiscal rules can encourage creative accounting; however, it is less likely when the social cost of a break-through fiscal target and an opportunity to be discovered are larger. The height of the probability of being discovered contributes to a true fiscal consolidation and reinforced transparency in budgetary procedures.

Fiscal councils

By taking a broader view on the fiscal consolidation needs, than rule based system is likely to do on its own, fiscal councils have a potential to help in fiscal consolidation. Fiscal councils contribute to a better fiscal performance in several ways: by providing an independent view on the fiscal policy, whether related to such a policy formulation, or monitoring and informing voters and other stakeholders when the fiscal policy is off-track, they can increase the political cost of fiscal laxity (Calmfors & Lewis, 2011; Mueller, 2008). However, the creation of a fiscal council may simple be an expression of a political commitment to consolidation. If there is no complete credibility, there will be no impact on performance, either, when the public support for consolidation disappears.

The fiscal council is complement to fiscal rules. However, the fiscal council can help politicians in deciding when a breach of rule is justified by economic circumstances and when the government should start consolidating. The full effectiveness of the fiscal council assumes its right to comment on whether the current policies are consistent with meeting long-term objectives even though they are consistent the with medium-term, especially if the latter are not explicitly linked to the long-term sustainability of public finances.

The fiscal council may mitigate certain problems of political economy. When a tendency towards excessive deficit results from over-optimistic forecasting, an independent fiscal council may remove the source of the deficit, although conservative forecasts in the budgetary procedures can foster this aim. In some SEE countries (including Serbia), it was confirmed that there is a connection between weak budgetary outcomes and systematic over-optimism: errors in budget balance forecasts are larger for countries running worse budget positions. However, although independent fiscal forecasting can correct the overly optimistic one, deficit biases coming from other pathologies, may be better resolved by other approaches, such as prudent budgetary assumptions (Hagemann, 2010).

The inclusion of the fiscal council in the budget process is an important element that determines its impact on the fiscal policy. A delegation of macroeconomic forecasts for the budget preparation is an example of the strong involvement of the body in the budget process. Registered short-term experience in Serbia and Croatia shows that independent forecasts result in more realistic macroeconomic scenarios, used to having a particular policy decision adopted.

Medium-term budget framework (MTBF)

The importance of the MTBF, as a fiscal institution, in which the horizon of fiscal planning is extended beyond the annual budgetary calendar, comes from the fact that most fiscal measures have budgetary implications going much beyond yearly budgetary cycle. A well-designed MTBF reflects the impact of the past budget commitments, as well as the cost of a new policy measure (EU Commission Assessment, 2011).

The medium-term budgetary objectives incorporated into the MTBF account for a weaker form of commitment than fiscal rule targets: however, highlighting the future cost of the current policies, they can enhance fiscal discipline. The medium-term budgetary objectives facilitate monitoring providing benchmarks against which budgetary developments can be assessed over time.

Complementarities between multi-annual expenditure rules and the MTBF must be followed in order to maintain medium-term budgetary objectives. An appropriate breakdown of the projected expenditure limits to the main expenditure areas is necessary in order to incorporate the spending policy priorities and anticipated expenditure adjustment in the medium-term fiscal planning. Serbia and Montenegro have not managed to do this for a long time, while other countries in the region have made advancement in this respect. It is useful to supplement expenditure projections by realistic revenue projections based on prudent macroeconomic assumptions. The baseline projections and macroeconomic assumptions should be supplemented by alternative scenarios, because this allows the identification of the budget priorities in the case of an unforeseen increase or decrease if revenue materializes, which in turn could reduce the need to resort to ad hoc budget revisions.

It is usually recommended that a fixed form of the MTBF be adopted relying on the binding spending limits because fixed frameworks imply that budgetary objectives, such as expenditure targets for example, are firmly set and do not change over time, except in the case of unexpected, extraordinary events during the time period covered by the framework. Fixed frameworks are limits to a discretionary fiscal policy, in contrast to flexible frameworks, which allow for annual target revisions according to such a policy changes (Cottarelli, 2010; EU Public Finance, 2010).

The actual results of the previous budget year should be compared with the initial projections provided in the MTBF. Differences and discrepancies must be explained and justified, and measures implemented to neutralize medium-term deviations from the path of fiscal projections must be disclosed. All of these activities in Serbia and other SEE countries, except for Croatia, are not performed regularly and in detail, because there is no expert capacity for that. Therefore, it is evidenced that the biggest drawback of the majority of the MTBF lies in their low impact on the annual budget law.

Commitment that projections and targets from the MTBF forms the base for the preparation of the budget law, implies a stronger role of the Parliament in preparing the MTBF: the projected fiscal paths, especially targeted expenditures, should be presented, discussed and approved in the Parliament, before the submission of the annual budget law. In all SEE countries, parliamentary debates have almost no influence on the budget formulation and its execution. The drafts of the state budget, the consolidated budgets and the laws on the execution of the budget submitted to the Parliament, usually submitted for approval in mid-November leave us with an insufficiently long time period to analyze and formulate the full opinion of the budget in mid-December. The amendments proposed by members of parliament are rarely accepted. It was noted that, in Serbia and Montenegro, there are tendencies showing the above-mentioned relationship is going the opposite direction (i.e. targets discussed in the first year of the MTBF are revised annually according to the figures of the annual budget law). This pathology leads to the creation of a short-term fiscal policy and, hence, one cannot talk about the implementation of time consistent budgetary strategies.

Budgetary procedures

When it comes to the impact of budgetary procedures on the formulation and implementation of fiscal consolidation, the following points are important at first sight: transparency and realistic economic assumptions. Transparency requires reliable and timely budgetary data, standard accounting practices and a comprehensive coverage of the budget law. Transparency is crucial for the responsibility of the fiscal authorities. When it comes to economic assumptions, it is important that there be some independent reviews of the same (in Serbia, the Quarterly Monitor and Monthly Analyses and Forecasts reviews proved very useful) and that independent bodies offer their economic scenarios for the budget preparation.

The budgetary centralization in the planning and approval phases is one of the most important aspects of the budget process because of its significant impact on fiscal outcomes. The fragmented budget preparation made by a large number of actors results in a deficit bias because of the common-pool problem. Hence, a higher degree of the centralization of the budget preparation is especially recommended in countries with insufficient central control over the budget process (Serbia, Montenegro, B & H and Albania). A stronger centralization can be achieved by strengthening the fiscal rules and the MTBF, or by strengthening the role played by the Minister of Finance or the Prime Minister, who will have the final say in resolving disputes between various ministries.

Top-bottom budgeting can act in directing a greater centralization. The successful implementation of top-bottom budgeting is closely associated with the establishment of effective binding spending limits and the existence of a Minister of Finance rather decisive to introduce more fiscal discipline than the traditional bottom-up approach, where total spending is obtained as the sum of individual expenditures required by all ministries and agencies.

Budgeting for performance is a practice based on the evaluation of spending programs against the achievement of their political objectives: the resources allocation in the budget preparation is then based on the effectiveness of the past consumption. Serbia and other SEE countries, except for Croatia, have almost made no progress in this area. The absence of any regular tracking of the objectives/expenses and the regular reviews of expenditures have been noted and referred to as a particular deficiency.

Table 2 below contains a preliminary assessment of compliance with the institutional requirements for fiscal consolidation in SEE countries according to the phases of the consolidation process considered in this research, the formulation of a consolidation plan and an implementation plan through the budget process.

A comparative review of the development degree of institutions along all the three phases of the consolidation process in Serbia and Croatia is demonstrated by Figure 3.

Table 2 Assessment of compliance with institutional requirements for fiscal consolidation (descending from A)

	Serbia	Montenegro	B & H	Macedonia	Croatia	Albania
Formulation of plan consolidation						
a. Medium term fiscal objectives	B	D	E	D	C	C
b. Medium term budget framework	C	E	B	C	B	B
c. Independent fiscal council	B	F	E	F	C	D
d. Performance orientation	E	C	D	C	A	B
Implementation of plan						
1. Top-Down budgeting	C	D	B	B	A	C
2. Parliamentaryapproval	D	D	F	B	D	D
3. Budget execution	C	D	C	C	C	C

Source: Presentation of preliminary results based on Fiscal Affairs Department, IMF and own estimates

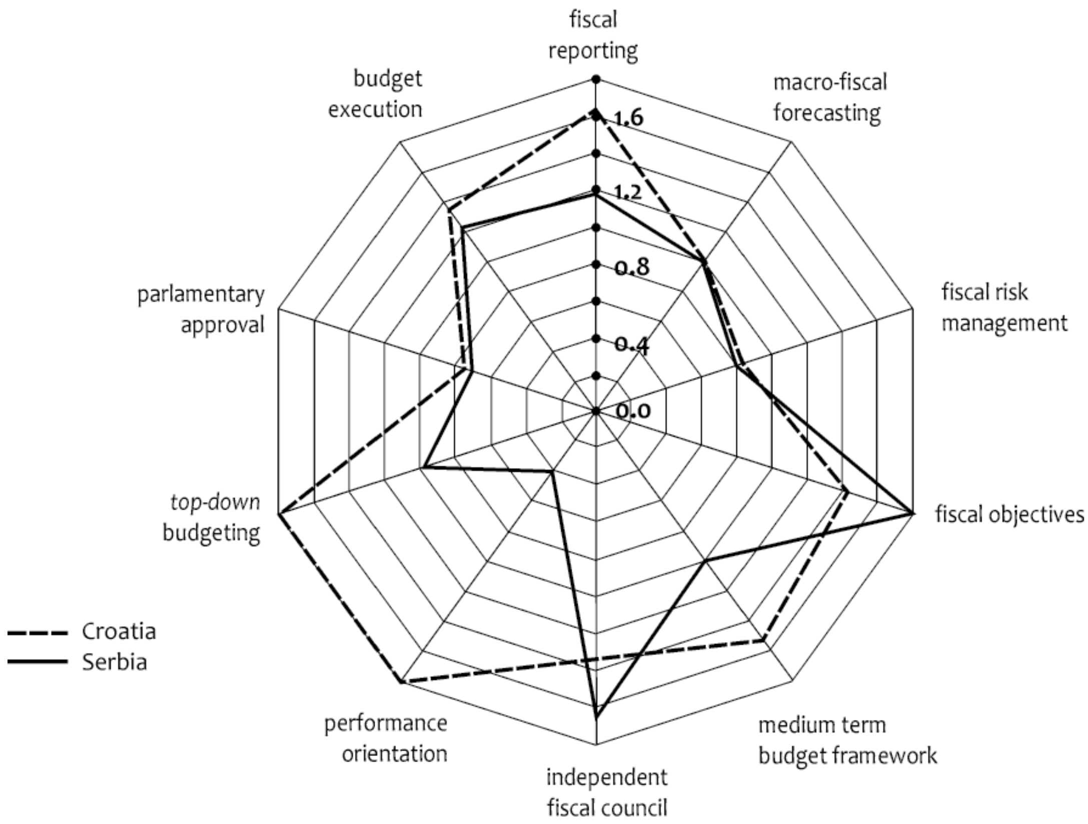

Figure 3 Comparison of the development degree of institutions in Serbia and Croatia

CONCLUSIONS

Analyzing the relevant political factors and the development degree of institutions needed to support fiscal consolidation, the paper is on the track of those researches which have a priority in seeking the ways for restoring the stability and sustainability of the public finances in the SEE countries.

A successful fiscal consolidation requires transparent and credible plans and proactive communications strategies because only in this way is it possible to change expectations of the key economic and financial actors in a time of a debt crisis.

Finally, it has to be pointed out that explicit institutional arrangements, such as fiscal rules and the medium-term budgetary frameworks cannot be a substitute for political commitment to fiscal discipline. Strong political willingness for conducting sound fiscal policies is necessary while new institutions and procedures are introduced or the existing ones are reformed in order to ensure a success in the management of the public finances. In Serbia and other SEE countries, the fiscal rules and the fiscal councils have only recently been introduced and there is still a little evidence of their full effect on the policy. The experience of other countries can help create an adequate domestic fiscal framework; yet, at the same time, it is necessary that different economic, institutional and political features in each individual country should be taken into account.

ACKNOWLEDGMENTS

The research in this paper was conducted within Project No. 179065, funded by the Ministry of Science of the Republic of Serbia.

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Received 12 June 2012,
after one revision,
accepted for publication 9 July 2012

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