

# Policy Brief

## Public debt in Southeast Europe

### Why to enable public participation?



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# Policy Brief

## Public debt in Southeast Europe why to enable public participation?

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In the face of the European debt crisis, public finance monitoring took center stage in economic discussions. These events have reconfirmed the adverse effects of the rising costs of an ever-growing public debt on economic growth, monetary stability and public finance. The 2008 global economic crisis highlighted the importance of fiscal intervention, and after more than two decades of the neoclassical paradigm and a non-fiscal dominance, brought back fiscal activism and the Keynesian ideas and measures at the top of government agendas. The drastic worsening of many nations' fiscal health, as a result of a decreased economic activity and of various fiscal packages for the financial sector and the economy as a whole, complemented by budgetary pressures from an aging population, activated debates on the size, sustainability and the consequences of budget deficits and public debt. Before the crisis the focus of debates and research on the issue of monitoring of public finance was on developing and emerging market countries. Recent events, however, especially the European debt crisis, when some EU member states faced difficulties in accessing financial markets, proved that fiscal sustainability problems are not typical only of developing countries, but are also a real problem for developed countries with a growing public debt, stagnant economic growth, unfavorable demographic trends and liabilities passed from the financial sector.<sup>1</sup>

Transparency of public finance refers to the extent and ease with which citizens can access information about and provide feedback on government revenues, allocations, expenditures, government's economic priorities in terms of policies and programs. Monitoring of public finance entails using such information to analyze, critique, and track government finances in order to provide this feedback. Transparency is a prerequisite for public participation and accountability, which are instrumental for a democratic and legitimate budget process. Both transparency and monitoring efforts also help remove institutional bottlenecks that result in delayed budget allocations, thereby jeopardizing the delivery of vital services to people. Even though they have a far-reaching impact on the lives of people, opening up public finances beyond the exclusive domain of policy makers and administrators is a relatively recent phenomenon that has gained momentum in the last two decades.<sup>2</sup>

Civil society organizations engaged in public finance focused work contribute to public expenditure management and oversight in several ways. First, they provide one of the few sources of critical and independent information on the impact of the budget on poor and low-income citi-

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1 Tanner, E., 2013. Fiscal sustainability: A 21st century guide for the perplexed; Working Paper No. 13/89. International Monetary Fund

2 Global stock-take of social accountability initiatives for budget transparency and monitoring: key challenges and lessons learned (English), 2013, available at: <http://documents.worldbank.org/curated/en/457241468340847491/Global-stock-take-of-social-accountability-initiatives-for-budget-transparency-and-monitoring-key-challenges-and-lessons-learned>

zens. Second, they can help build public finance literacy among citizens and facilitate discussions and debates on public finance issues within civil society. Third, by collating, synthesizing, and disseminating information on public finances, adds new data into the budget process. Finally, civil society public finance groups provide training on public finances to citizen groups, the media, and legislatures, thereby strengthening the capacity of all of these groups to exercise oversight over budget process and to demand accountability from government. Although civil society is a relatively new actor in public budgeting, evidence that they are having a positive impact on decision-making and implementation is beginning to emerge.<sup>3</sup>

In the aftermath of the crisis, the Western Balkans experienced difficulties in regaining control of their public finances. Debt has increased sharply, reaching the levels of Central and Eastern European countries. Some countries in the region experienced rising public debt to an extent that their sustainability might become questionable. The significant reduction of the debt burden that took place during the boom years was thus largely undone.<sup>4</sup>

The studies carried out for this report considered, on the one hand, the national public finance contexts and, on the other, the relevant policy prescriptions of the IFIs, EU accession requirements, and the developments in Eurozone/EU monetary and fiscal policy, in the following areas: fiscal consolidation and accumulation of a primary surplus; fiscal rules and pro-cyclical fiscal policy; transparency and accountability of governance of public finance; participation of CSOs and the public more generally in monitoring public finance; consolidation of public spending as the basis for increased capital investment; fiscal consolidation and restructuring of the public sector to increase competitiveness and growth; financing and nature of capital investments. It is very important to detect debt vulnerabilities and to react in a timely manner. The study analyzes the recent debt trends in Bosnia and Herzegovina, Bulgaria, Kosovo, Macedonia, Montenegro, Serbia, and Slovenia with the aim of warning about possible problems with long-term debt sustainability:

- The pre-crisis years were favorable for the Bosnia and Herzegovina, Bulgaria, Kosovo, Macedonia, Montenegro, Serbia, and Slovenia in the fiscal area. Positive global expectations and developments, as well as solid economic growth in the region (the average growth in the pre-crisis period 2002-2007 was around 5%) led to a stable period and positive budget outcomes, resulting in periods of balanced budgets and even surpluses in some of the countries.
- **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, together with rising expenditures to cover increased social security payments, and in some countries bank bailouts, **set the stage for large deficits across the Balkan countries** (especially Western Balkans).
- **The average debt in the analyzed countries went up from 25% of GDP in 2007 to 51% in 2016.** Kosovo is the only country that has managed to keep debt lower than its pre-crisis level. All other countries are struggling to get their fiscal positions back on track. Slovenia experienced the largest jump in indebtedness by 61 p.p. from 2008 to 2015 (from 22% to 83% of GDP).
- **The rising trend triggered alarm bells concerning the long-term sustainability of public finances, especially given that the debt tolerance level is lower for lower income economies.** This makes this unique analysis even more desirable and significant. Unsustainable

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3 The Role of Civil Society Organizations in Auditing and Public Finance Management , by Vivek Ramkumar and Warren Krafchik The International Budget Project, available at: <https://www.un-ngls.org/orf/cso/cso10/Ramkumar.pdf>

4 Koczan, Z. 2015. Fiscal Deficit and Public Debt in the Western Balkans: 15 Years of Economic Transition. *IMF Working paper*, European Department. July

public finances and rising public debts are a threat to some of these countries. Thus, closely monitoring the debt movements is necessary and a timely response to unsustainable developments is of crucial importance for maintaining macroeconomic stability.

- **All the countries except Montenegro narrowed their fiscal deficit in 2016, showing signs of fiscal consolidation.** The average deficit in the countries of interest fell from 3% in 2015 to 1.6% in 2016. Montenegro's deficit remains almost unchanged at 6% of GDP. However, the average projected deficit for 2017 is 2.3% of GDP.
- At present the mechanisms for enabling the CSO sector to participate in the monitoring of public finances are weak and far from transparent. Governments that in some extent provide mechanisms for CSO oversight must be obliged to demonstrate that CSO feedback has been considered and provide justifications concerning whether or not it has been taken into account in the framing and execution of policy.

## Legal framework on public debt

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The scope of the domestic legal framework governing public debt management may vary from country to country. Constitutions and primary legislation (Acts of Parliament, Laws, Decrees and similar), provide the broad legislative architecture within which public debt is contracted and managed. This is usually supplemented by a secondary legal framework (regulations, rules, guidelines, and circulars, among others) to elaborate on operational aspects of the framework. The legal framework should define what constitutes public debt. "Public debt" is often used to refer to debt of the general government and in some cases, the debt of the entire public sector. Whether the broader public-sector debt is included or excluded from the scope of application of the legal framework will vary from country to country, depending on the nature of the political and institutional framework. **The scope of public debt under the legal framework should ideally cover all debt instruments representing liabilities of the public institutions covered by law.** From a debt management perspective, the IMF and World Bank recommend that the scope of PDM should encompass the main financial obligations over which the central government exercises control, including both marketable and non-marketable debt. From a statistical perspective, the IMF defines total gross public debt as all liabilities that are debt instruments (i.e. financial claims that require payment of interest and/or principal by the debtor to the creditor at a date, or dates, in the future).<sup>5</sup> **As regards the analyzed countries, they all have enacted Law on borrowing or law on public debt (except Montenegro).**

## Fiscal Rules

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**Policy tools that promote fiscal sustainability, such as fiscal rules, have garnered attention in countries that face problems of fiscal consolidation. All Western Balkan countries except Macedonia and Bulgaria have adopted fiscal rules.** Most of these rules are amendments to budget laws that introduce numerical target to ensure long-term fiscal sustainability, discipline, and transparency. A fiscal rule is a long-lasting constraint on fiscal policy through numerical limits on budgetary aggregates. This implies that boundaries are set for fiscal policy which cannot be

frequently changed.<sup>6</sup> Their main objective is to strengthen the credibility of fiscal policy and the fiscal authorities. Well-designed and effectively implemented fiscal rules can provide greater transparency, make fiscal policy more resilient to the demands of public agencies and interest groups, and create an explicit commitment on the part of the government to achieving its fiscal goals.<sup>7</sup>

Nevertheless, there are two views on public debts and deficits, like on the need for fiscal rules. The opponents of fiscal rules may reply that fiscal policy adequacy criterion lies on the employment level, inflation, interest rates, and not on a priori public debt or deficit levels. They may request rules consistent with the macroeconomic stabilization objective. For neo-classical economists, the rise in deficits and public debts in recent years shows that rules are needed to avoid this drift. For Keynesians, this rise was necessary and fiscal rules would be harmful if they prevent fiscal policy to play.<sup>8</sup>

Fiscal rules also depend on political leaders who are willing to operate within the constraints, even when they are thereby compelled to take unpleasant actions such as reducing services or boosting taxes. When political will is lacking, as is often the case, compliance will be weak. However, the point is fiscal rules have a limited effective life and must be reinvigorated or replaced from time to time.<sup>9</sup> Nevertheless, too rigid rules implemented simultaneously in Europe will reduce GDP growth which will have vicious effects: lower output growth will generate lower tax receipts, will increase the debt-to-GDP ratio, government balance targets will not be reached; the rise in unemployment and political and social tensions will raise the fear that the country does not stick to the rule.<sup>10</sup>

Fiscal policies should be given back more rooms for maneuver, through implementing strong measures at the EU and world levels, fighting against tax evasion, abolishing tax heavens, and restoring the ability of countries to tax multinational companies' benefits, high incomes and wealth. Financial globalization should step back, because it is a source of economic instability and of excessive misappropriation by the finance sector.<sup>11</sup>

## Characteristics of the public debt current situation in every country

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As classified by the World Bank, countries with public debt of 40% of GDP are considered lower indebted, those with debt of 40% - 60% of GDP are considered moderately indebted and those with debt above 60% of GDP are considered highly indebted countries. For developed countries, studies show and refer to the prudential limit of 60% of GDP (this coincides with the Maastricht

6 IMF Country Report No. 17/125. 2017 Article IV Consultation – press release; staff report; and statement by the executive director for the Republic of Slovenia

7 World Bank. 2017. Western Balkans - Regular Economic Report No.11: Faster Growth, More Jobs, World Bank Group, Spring

8 Do we need fiscal rules? Catherine Mathieu and Henri Sterdyniak (OFCE), available at: [https://www.boeckler.de/pdf/v\\_2011\\_10\\_27\\_mathieu\\_sterdyniak.pdf](https://www.boeckler.de/pdf/v_2011_10_27_mathieu_sterdyniak.pdf)

9 The Role of Fiscal Rules in Budgeting by Allen Schick\*, OECD, 2003, available at: <https://www.oecd.org/gov/budgeting/43494591.pdf>

10 Ibid.

11 Ibid.

criteria). In less developed countries and developing countries the prudent limit is estimated at 40% of GDP. The countries from the region can be divided into two groups according to their gross general government debt in 2016: countries with debt levels above 70% of GDP, making them highly indebted (Montenegro, Serbia and Slovenia) and countries with debt levels below or slightly above 40% of GDP (BiH, Bulgaria, Kosovo and Macedonia). However, even for the lower indebted countries, there is an apparent rising trend of debt (except in Kosovo). For example, it has increased almost threefold since 2006 in BiH, in large part because of budget support loans, due to a structural budget deficit. For six years (2008-2013) Bulgaria had the lowest national debt to GDP ratio in the EU second only to Estonia. In 2014 the debt ratio jumped by 7 % and reached a level of 26.9% and has continued to rise with more steady steps peaking at 29.5% at the end of 2016.

## Independent regulatory and oversight bodies/ accountability

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Audits of government financial statements should be conducted regularly and publicly disclosed. Public disclosure of the review by the audit bodies would strengthen the accountability framework for debt management. A national audit body, responsible for auditing government operations, should provide timely reports on the financial integrity of the central government accounts. In addition, there should be regular audits of debt managers' performance, and of systems and control procedures.<sup>12</sup> In Bosnia and Herzegovina, all four main government levels have their own SAs (supreme audit institution), each with its own laws and regulations in this area. In Bulgaria, the National Audit Office (hereinafter NAO) is the body that exercises control over the implementation of the budget and other public resources. The State Audit Office (SAO) is a supreme audit institution in Macedonia, which provides support to the Parliament for execution of its jurisdiction, through identification and presentation of irregularities and illegal operations of audited entities, uncovered by the performed audits. In Montenegro, the State Audit Institution, which is by Law an independent and supreme state audit body, is in charge of analyzing the state budget. According to article 92 of the law on the budgetary system that regulates external audit, the annual financial statement of the Republic of Serbia and annual financial statements of the organizations for mandatory social insurance shall be subject to external audit, pursuant to the provisions of the law regulating the jurisdiction the Supreme Audit Institution.

## Fiscal Council

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The crisis enhanced the trend of establishing and strengthening independent fiscal institutions, such as the Fiscal Council. A fiscal council is an independent body that usually has a mandate to set more objectively the fiscal projections and to assess and monitor the implementation and effects of fiscal policy. Since the onset of the crisis, many countries introduced a fiscal council. According to Wyplosz (2012),<sup>13</sup> the advisory fiscal councils make a notable contribution to fiscal

12 Guidelines for public debt management prepared by the IMF and the World Bank in 2001

13 Wyplosz, C. (2012) Fiscal Rules: Theoretical Issues and Historical Experiences. NBER Working Paper 17884. National Bureau of Economic Research, available at: <http://www.nber.org/papers/w17884>

discipline in the countries where politicians are willing to listen. In Bosnia, A Fiscal Council was set up in 2008 and in Serbia in 2011. Bulgaria and Slovenia have ratified the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, the fiscal component of which is the Fiscal Compact. Following that, Bulgaria enacted the law on Fiscal Council and automatic corrective mechanisms and established a Fiscal Council and nominated its members in 2015, while Slovenia established the Fiscal Council complying with the Fiscal Rule Act adopted in 2015, but nominated the council members much later, in March 2017.

## Public Debt Management

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The main objective of public debt management is to ensure that the government's financing needs and its payment obligations are met at the lowest possible cost over the medium to long run, consistent with a prudent degree of risk. Debt management needs to be linked to a clear macroeconomic framework, under which governments seek to ensure that the level and rate of growth in public debt are sustainable. Public debt management problems often find their origins in the lack of attention paid by policymakers to the benefits of having a prudent debt management strategy and the costs of weak macroeconomic management.<sup>14</sup> In BiH, a mid-term debt management strategy (MTDMS) document was published in March 2016, based on strategic documents produced by the entities in December 2015 for the period 2016-2018. The Bulgarian Ministry of Finance develops a government debt management strategy for the respective medium-term period of three years, which has to be approved by the Council of Ministers. Pursuant to the Law on Public Debt, the Parliament of the Republic of Macedonia adopts the Public Debt Management Strategy Public Debt Management Policy is set for a period of three years and became part of the Fiscal Strategy, as result of the amendment of the Law on Public Debt from 2011. The Montenegrin Law prescribes that the Government, with the opinion of the Central Bank, adopts the Debt Management Strategy, which defines a framework borrowing program for a three-year period, guidelines for risk assessment for taking borrowings, guidelines for management of debt, cash, guarantees, and borrowings, and other matters significant for debt management. However, inputs from the Central Bank are not obligatory. All these categories are incorporated into the current Strategy which refers to the 2015 - 2018 period. Slovenia prepares a Fiscal Strategy.



# Recommendations

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## 1. Strengthening Public Debt Management Mechanisms

- **Inclusion of all liabilities of public institutions in legal definition of public debt**  
The scope of public debt under the legal framework should ideally cover all debt instruments representing liabilities of the public institutions defined in the law. It should encompass the main financial obligations over which the central government exercises control, including both marketable and non-marketable debt. Only once all liabilities are included is it possible to assess the fiscal position of the government and thus properly manage public finances.

## 2. Greater Transparency and Accountability in Public Finance

- **CSOs participation in monitoring public finances**  
Governments must systematically introduce mechanisms enabling the CSO sector to participate in the monitoring of public finances, from the performance of budget execution to reviews of budget and tax policy. Greater participation by citizens in affairs that directly concern them is in itself a public good and is a stimulus to greater transparency and accountability in public finance.

- **Independent and Public Auditing of Public Debt Management**

- The debt management activities should be audited annually by external auditors and audits of government financial statements should be conducted regularly and publicly disclosed. The State Audit Office should have a legal obligation to inform and educate citizens in finance issues, of the fiscal performance of government and state institutions, and of the work of the audit office itself.

- **Development of a Citizens debt audit mechanism and publication of a Citizens budget to fully involve the public in public finance monitoring**

- There should be legally enshrined regular and independent mechanisms for public involvement in auditing public debt. In order to monitor the movement of public finances and to ensure long term fiscal sustainability there should also be similar mechanisms for public participation in the budget process and in the formulation of the public budget.

- **Introduce a legal obligation of governments to publish Pre-Budget Statements**

- In order to enable the public to participate in the formulation of alternatives, governments should publish Pre-Budget Statements and provide fully comprehensive supporting budget documents (mid-term budget framework, fiscal strategy, EU PEP-pre-accession program, etc.), as well as to provide additional detailed information on the proposed budget that will allow easier monitoring of the effects of the budget and determining the fiscal position of policy makers. Similarly, governments should provide the public with regular public debt management reports which list the different components of the debt, how they are financed and at what cost to the public. In order for this information to assist public deliberation governments must be legally obliged to regularly inform the public as to the basis of state finances in relation to taxation of incomes, business, consumption and excises.

- **Introduce a legal obligation of governments and legislatures to formally consider and respond to 1) the findings of the State Audit Office report on the budget, and 2) to the Citizens Debt Audit, and 3) Citizens Budget**

- Without a legal framework, there is no mechanism that can hold governments to account for their fiscal policy, whether from the side of the executive (audit office) or civil society (citizens audits), between elections. Such a framework would serve long term fiscal sustainability by enabling regular deliberation by legislatures on policy efficacy and alternatives.

### 3. Independent and fair procedure for debt resolution

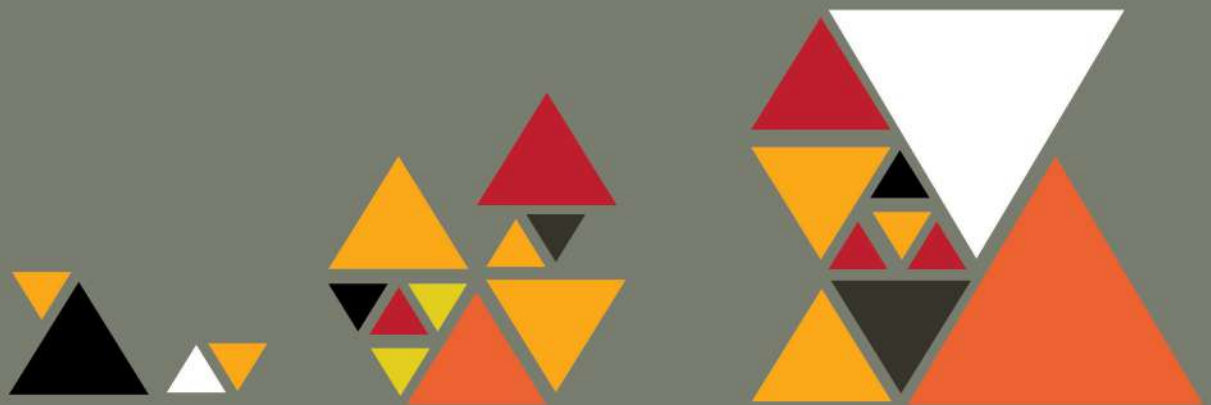
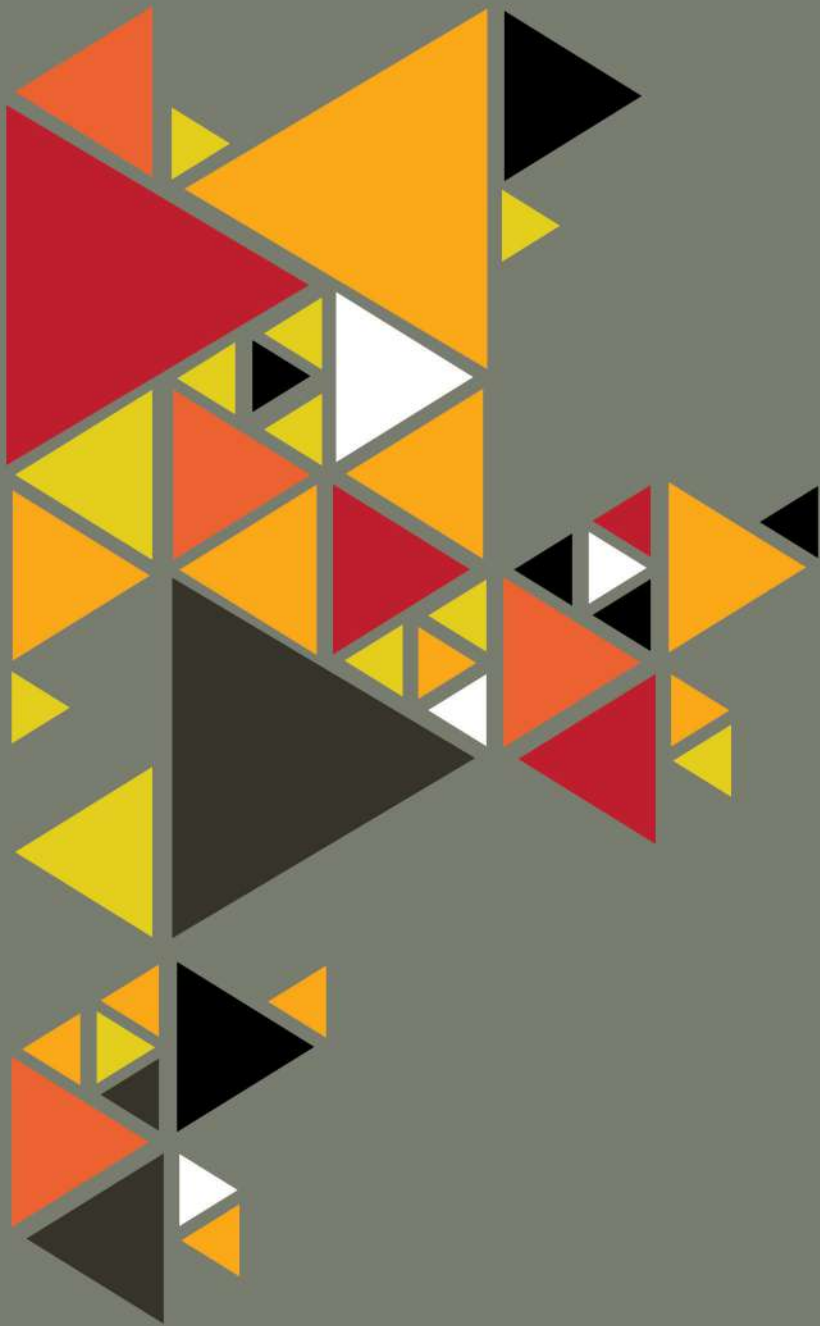
• At present mechanisms to resolve public debt crises are led by creditors, based on ad hoc procedures and ignore the issue of whether the debt is unsustainable or illegitimate. The sustainability of debt is only seen as a financial problem, ignoring development needs and human rights obligations. A sustainable solution to public debt requires an international mechanism that:

- is based on **an independent and fair procedure for debt resolution, which should assess the legitimacy and the sustainability of countries' debt burdens;**
- takes into account legal human rights obligations, including provision of essential services, when assessing a government's capacity to service its debt, and considers the impact of ongoing debt servicing, hence **supporting a human rights-based approach to debt sustainability;**
- holds lenders and borrowers to account for irresponsible behavior by auditing the legitimacy of lenders' claims and **demanding the cancellation of unjust debts based on corrupt, irresponsible or undemocratically contracted loans which did not benefit the people of the borrowing country; gives all stakeholders, including civil society, the right to participate in the resolution of public debt crises through the mechanisms of the citizens debt audit and citizens budget.**<sup>15</sup>



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За Земята  
Прители на Земята България

