Fiscal Policy and Economic Growth in Europe and Central Asia

Even with substantial progress in fiscal adjustment, governments are still quite large

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Economic growth in most transition countries in Europe and Central Asia (ECA) since the late 1990s has been accompanied by significant reforms in public finances. Government spending has fallen in line with the changing role of the state, and tax revenues have picked up from low levels as tax policies have been restructured and tax administrations strengthened. Fiscal deficits have narrowed as a result of increasing revenues and controls on spending, and public debt ratios have fallen.

Even with this progress in fiscal adjustment however, ECA governments are still relatively large on average (see Figure 1) compared with those in non-ECA countries at similar levels of per capita income. Governments are particularly large in Central and Southeast Europe (SEE), where total public spending averages close to 45% of GDP. Generous social protection schemes, which mirror those in higher-income countries, account for most of this size difference.

Does Government Size Matter for Economic Growth?

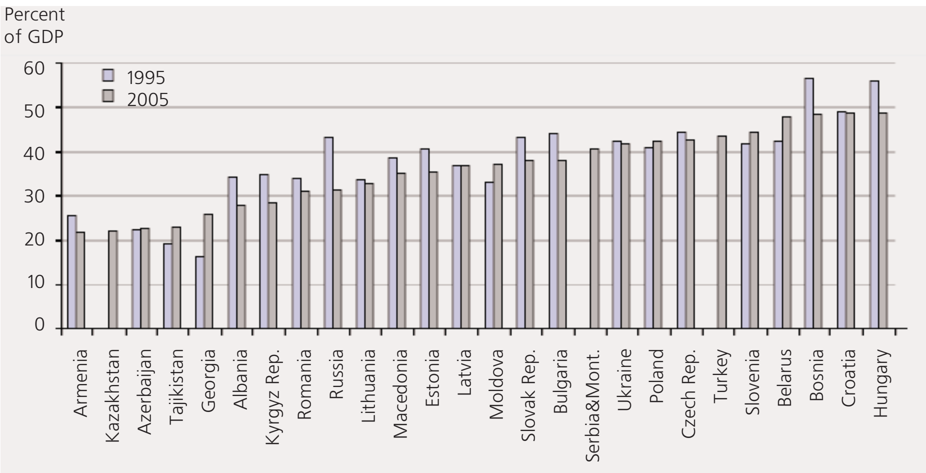
Our detailed analysis finds that the overall size of government influences economic growth rates in ECA, but that this effect depends on the state of governance. Bigger governments can hinder growth in countries with weak governance, but this effect is nonlinear: below about one-third of GDP, the size of government is not correlated with growth, but once public spending exceeds 35% or so of GDP, increasing government size can have a negative impact on growth. Strong governance mitigates this negative effect, which is one reason that big governments do not necessarily reduce economic growth in some higher-income OECD countries.

Multiple reasons explain why large governments can impede growth in countries with weak governance:

- Large governments are more likely to run fiscal deficits during economic downturns, particularly where public spending is inflexible because of weak budgeting systems, reliance on earmarks, and high public employment;
- The high rates of taxation needed to fund big governments can distort private activity, particularly if tax administrations are weak;
- A large government presence in particular sectors may be accompanied by anticompetitive regulations on private sector participation;
- Government spending may be misallocated as a result of corruption or poor capacity, sapping productive resources from the economy.

While strong and capable governments may be able to avoid many of these problems through tight budget planning and efficient tax administration, countries with weaker governance should keep public spending and taxation to more modest levels if they want to spur economic growth.

Figure 1. Total Public Sector Spending, by Country in ECA, 1995 and 2005



How to Improve the Efficiency of Public Spending?

Patterns of public spending affect economic growth in at least two ways. First, some categories of activities appear to spur growth more than others. High levels of spending in "unproductive" areas (e.g. public consumption and transfers) can have a negative impact on growth, while spending in "productive" areas (e.g. investment and social sectors) can promote growth. Second, within each broad category of spending it is possible to allocate resources more or less efficiently.

Here again the state of governance matters a lot. Higher spending in productive areas can lead to higher growth in countries with strong governance, and in such countries higher spending in unproductive areas may not necessarily be harmful to growth. In contrast, growth in countries with weak governance tends to be slowed by higher levels of unproductive spending and the higher taxes that are required to fund it, and such countries do not necessarily benefit from spending in productive areas.

While ECA countries should try to shift spending toward productive areas to any extent possible, it is even more important that they enhance the efficiency of spending in such areas as infrastructure, education, health, and pensions.

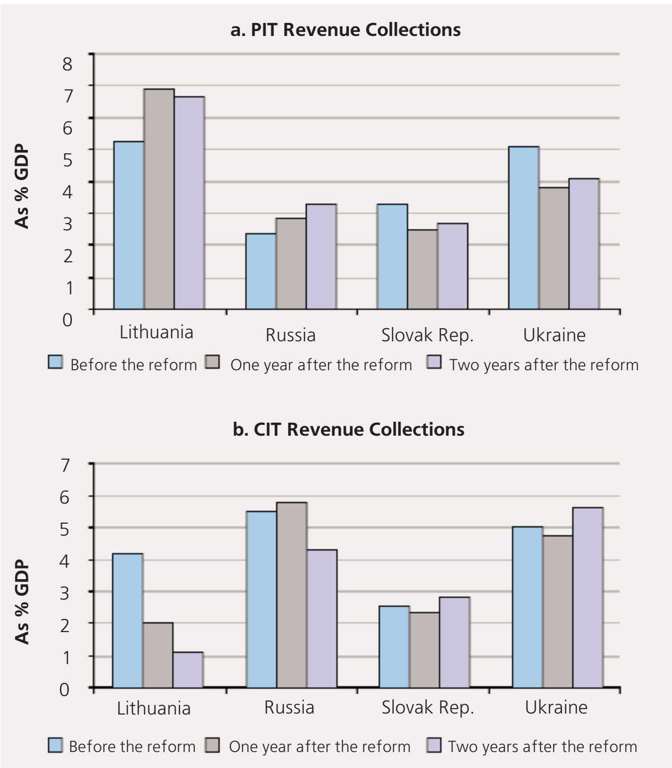
- *In infrastructure*, further investments, a stronger focus on operations and maintenance, and better management of public investments are necessary.

But the primary emphasis still needs to be on promoting efficiency and strengthening governance, particularly in the SEE and CIS regions. There is also scope for more private sector participation, whether through divestiture or management contracts. Yet, the role of government will continue to be critical, especially in ensuring financial viability and promoting fair competition.

- *In education*, public spending is achieving reasonably good results in many ECA high-growth countries, which have above-average school enrollment and learning outcomes given their share of public education spending in GDP. Yet the countries could benefit from moving to financing on a per capita basis; integrating relatively expensive technical and vocational with general education schools; decentralizing school financing and management; and relying to a larger extent on private sources of financing for tertiary education to free up public resources for primary and secondary education.
- *In health*, the ECA countries tend to spend more than countries elsewhere for comparable outcomes, a sign of inefficiency and poor governance. The primary emphasis in ECA needs to be on enhancing the quality and efficiency of spending, e.g. through consolidating hospitals, moving toward standard basic benefits packages, containing the growth of pharmaceutical costs; putting in place adequate mechanisms for financing and risk sharing with a reasonably modest level of copayments (not to limit access for the poor).
- *In pensions*, ECA countries have a higher level of spending than fast-growing countries at similar income levels elsewhere. This is due to low retirement ages, broad coverage for disability, and the falling share of the population paying into public pension systems, aggravated by declining birth rates and the overall aging of the population. For middle-income countries, the best option would be to make the public contributory pension system fully self-financing and complement it with means-tested social assistance for those who are not covered. For lower-income countries, a universal or means-tested low-rate pension financed out of general revenues may be the best option.

Reducing Distortions in the Tax System

Figure 2. Changes in Personal (PIT) and Corporate Income Tax (CIT) Revenue Collection after Flat Tax Reform



ECA countries are pioneers in adopting flat income taxes, motivated primarily by a desire to simplify the tax system and to lower income tax rates to spur investment and growth. The revenue impact of flat tax reforms has varied (see Figure 2), largely reflecting different policy goals. In some countries, such as Slovakia, rate reductions have been tempered by an expansion of the tax base and by better compliance. In other countries, such as Ukraine, the benefits of simplicity are clearly visible but the lack of reforms in other areas (e.g. labor taxes and tax administration) has undermined potential improvements in compliance. The experience in ECA suggests that flat tax reform is less likely to have a negative impact on revenue collection if it is adopted during a period of strong economic growth and is complemented by improvements in tax administration.

However, even though income tax rates have been lowered dramatically in many ECA countries, payroll taxes remain high, discouraging compliance and imposing a tax wedge of 30-50% on employment. High labor taxes have a negative effect on rates of formal employment, on the return to capital and on growth.

The best way to reduce the labor tax burden and its effect on employment is to reform the social security system (most notably pensions and health care). In some countries relief from payroll taxes should be provided to those with the highest "elasticity" of labor demand, including low-skilled workers and new labor market entrants. ECA countries can also move towards replacing some social insurance benefits financed by employer and employee contributions with universal benefits financed out of general taxation, as some Western European countries have done.

Conclusions

World-wide experience offers some lessons that ECA countries can use as they try to formulate public finance policies that will promote economic growth while meeting the need for fundamental public goods:

- Macroeconomic stability is essential, because large budget deficits retard growth;
- Moderate levels of public spending — about one-third of GDP or less — are preferable when governance and public administration are not strong;
- Lower income and payroll tax rates can spur investment and employment.

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