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A Critical Assessment of Fiscal Policy and Impact on Economic Growth. Albanian and Transition Economies Case

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Abstract. The main focus of this paper is making a critical assessment of possible links that exists between public finance policies and growth during transition period in Albania. Based on panel data technique is tested the impact of government size and the effect of budget deficit in economic growth.

On revenue side of public finance are done important reform, such as the introduction of VAT and flat taxes for both personal income tax and corporate income tax. A common trend in the last years has been substantial deduction of corporate income tax. Based on taxation theory are also analyzed, the main determinants of tax performance in selected transition economies.

The main findings of this work are that both government size and fiscal deficit are important factors that influence growth performance. The study has found support for negative impact on growth of government size in transition economies.

In tax performance evaluation for transition economies, GDP per capita, share of agriculture and share of industry have the expected impact in accordance with tax literature and previous studies. Total government expenditure has a positive impact in tax collection. Shadow economy is important for tax performance; therefore in order for the government to increase tax revenue, the tax evasion should be reduced.

Keywords: fiscal, finance, tax, taxation, budget

1 Introduction

This article has two main objectives, first finding evidence that fiscal balance and government size are important for growth performance in developing countries, by supporting Keynesian view that the government expenditure could be used by government as growth enhancing instrument. The second purpose is analyzing the impact of introduction of flat tax reform in transition economies, and the main determinants of tax performance.

With the development of transition process and changing the role of the state in economy, the government expenditure has dropped significantly. In some countries such as Albania, Croatia fiscal deficit is relatively large relative to Maastricht criteria of assessment. In transition economies, based on large informal sector, the capacity of the country to generate revenues remains highly limited[i].

An important part of tax reform in transition economies was introduction of flat taxes. The fist countries that adopted flat tax was Estonia and Lithuania in year 1994, followed in late 2000 by Albania, Bulgaria, Czech Republic, Macedonia, Romania and Slovak Republic. The adoption of flat tax in transition economies was not pure, because was followed by deduction and free allowance, which made the effective tax rate to grow as income grow.

An important feature of tax reform was steadily decline of corporate income tax, and sometimes the countries have set the corporate tax at the same level of personal income tax. The significant differences between countries made the corporate income tax a significant incentive for transition economies.

In the first part of the article is measured the impact of government size and fiscal deficit as growth enhancing factor. In the second part based on the panel data framework is analyzed tax performance in selected transition economies relative to five sets of explanatory variables economic development, economic structure, open to foreign trade, general macroeconomic stability and institution development.

2 The impact of government size and fiscal deficit in growth

There is a lot economic research focused on relationship between government size and economic growth. Keynesian school supports using of government expenditure as a policy instrument in order to enhance economic growth. Adolph Wagner (1890)[ii], emphasize that the economic growth is a determinant factor of public policy. In lot empirical work, such as Yuk (2005), Vedder and Gallaway (1998), is found the empirical evidence that growth in government spending increases the GDP growth. Many studies supports that the relationship between government size and growth is not a linear relationship[iii]. Grimes (2003), Cooray(2008),Gwartney, Lawson and Holcombe (1998), have found evidence that the government provision of infrastructure, operation of market economy and a limit set of public goods has a positive impact on growth, but if government expands beyond its core functions impede growth. Chandra (2004), have found a negative impact on growth in short run of large government sector. Negative impact on growth was found also by Afonso, and Furceri (2008), that have found for OECD and EU countries that an increase of one percent point in total expenditure relative to GDP decrease growth respectively by 0.13(0.09) percent points. In some studies, are done efforts to evaluate the optimal size of the government from growth perspective, such as Pevcin (2004), Mavrov (2005) that have determined the optimal size of government round 22 percent of GDP.

Table 1: ***The primary public expenditure as GDP share and GDP per capita, by country***

	1990-1993	1994-1997	1998-2001	2002-2007
Albania				
Public expenditure as GDP %	40.75	30.65	32.98	29.06
Fiscal deficit as GDP %	-16.43	-11.20	-10.40	-4.56
GDP per capita (in US $)	386.43	805.28	1,128.73	2,207.18
Bulgaria				
Public expenditure as GDP %	47.85	40.53	38.65	36.98
Fiscal deficit as GDP %	-6.60	-5.48	0.88	1.48
GDP per capita (in US $)	1,393.4	1,289.85	1,599.83	3,067.48
Croatia				
Public expenditure as GDP %	38.1	40.98	53.65	49.60
Fiscal deficit as GDP %	-2.55	-0.45	-6.50	-4.27
GDP per capita (in US $)	2,673.3	4,003.08	4,531.1	7,790.12
Czech Republic				
Public expenditure as GDP %	49.23	42.53	42.95	44.66
Fiscal deficit as GDP %	-0.65	-2.35	-4.53	-4.45
GDP per capita (in US $)	3,033.58	5,225.25	5,855.25	10,632.72
Macedonia				
Public expenditure as GDP %	51.35	39.25	36.10	37.14
Fiscal deficit as GDP %	-11.6	-1.38	-1.38	-1.02
GDP per capita (in US $)	1,096.95	2,027.1	1,784.25	2,579.86
Hungary				
Public expenditure as GDP %	58.35	53.20	49.13	50.44
Fiscal deficit as GDP %	3.75	-6.28	-5.00	-7.53

GDP per capita (in US $)	3,510.95	4,332.78	4,952.9	9,423.08
Poland				
Public expenditure as GDP %	48.47	49.65	42.95	43.58
Fiscal deficit as GDP %	-1.83	-3.45	-3.55	-4.60
GDP per capita (in US $)	2,024.63	3,530.78	4,538.60	6,879.06
Rumania				
Public expenditure as GDP %	37.90	33.95	34.80	31.52
Fiscal deficit as GDP %	-2.30	-3.28	-3.90	-1.80
GDP per capita (in US $)	1,227.53	1,503.85	1,725.30	3,698.10
Slovak Republic				
Public expenditure as GDP %	68.40	59.60	56.15	39.34
Fiscal deficit as GDP %	-8.80	-1.88	-7.70	-3.65
GDP per capita (in US $)	2,422.35	3,579.00	3,893.48	7,513.5
Slovenia				
Public expenditure as GDP %	43.57	44.55	47.55	46.40
Fiscal deficit as GDP %	1.57	-0.20	-2.28	-1.97
GDP per capita (in US $)	6,330.03	8,168.60	8,669.15	15,717.34

Source EBRD report for transition economies 2008

Government expenditure has basically fallen with the development of transition process and changing the role of the state in economy.

From the reported dates could be easily noticed that Albania have the smallest government sector relative to other transition economies. Albania fiscal adjustments that have started since September 1992, is basically focused on expenditure cuts. Measure on the revenue side was introduction of VAT late 1997, after 1999 the adjustment occurred through cut on public expenditure[iv]. Romania is the second country with the smallest government sector, in which the primary public expenditure as GDP share is less than 1/3 of their GDP; other countries have a big government sector ranged from 35 to 50 percent of their GDP.

Fiscal deficit have been narrowed substantially quite for all countries under survey, with very few exceptions, such as the case of Slovenia that has a budget surplus in early transition period of about 1.57% relative to GDP and turned to a relatively small budget deficit in the last years of about 1.97% of GDP. Only in the case of Bulgaria there is a sustained budget surplus since year 1998. Large fiscal deficits have been present in Hungary, Poland, Czech Republic and Albania in the last years[v].

3 Empirical assessment of fiscal budget and government size in growth

Based on Fisher and Sahay (2000) methodology is investigated for two possible links between public finance policy and growth. In economic literature higher economic growth is associated with lower fiscal imbalances. In order to finance the large government deficit the government has to borrow from the private sector, in endogenous growth theory changes in saving rate have an impact on long term growth of output.

The relationship between government expenditure and growth appears to be generally negative for transition economies based on the fact that larger government sectors are more likely to run larger fiscal deficits, misallocation of government spending because of corruption, and high rates of taxation need for big governments.

The estimated regression:

$$LGDPP = \beta_0 + \beta_1 LCPI + \beta_2 Fiscal\ Balance + \beta_3 Budget\ Expenditure + \beta_4 Reform\ Index$$

Table 2: Regression Results, Dependent variable total natural logarithm of GDP per capita, fixed effect estimation, sample for ten countries
Method: Pooled least squared

	Coefficient	Std. Error	t-Statistic	Prob.
L(CPI)	-0.079100	0.021576	-3.666093	0.0003
Fiscal Balance	-0.028343	0.009257	-3.061783	0.0026
Budget expenditure	-0.003203	0.005224	-0.613381	0.5405
Index of reform progress	0.464414	0.054177	8.572147	0.0000
Country fixed effect coefficients				
Albania	6.789901			
Bulgaria	6.870092			
Croatia	7.865810			
Czech Republic	7.861708			
Macedonia	7.689981			
Hungary	7.101974			
Poland	7.518439			
Rumania	7.049678			
Slovak Republic	8.450508			
Slovenia	7.933089			
R-Squared	0.887289	Mean depen var	8.201062	
Adjusted R squared	0.877253	S.D depend var	0.830275	
S.E. of Regression	0.290889	Sum squared resid	12.35401	
Durbin-Watson stat	0.424112			

Source: Calculations of Authors

Based on the empirical data reported on the above table, all the explanatory variables are statistical significant with the exception of budget expenditure relative to GDP share, which account for measuring the size of government sector. The sign is negative, in accordance with empirical studies for transition economies. Gray, Lane and Varoudakis (2007), have found that overall size of government influences economic growth, but the rate of this effect depend on the state of governance. Bigger governments can hinder growth in countries with weak governance, but this effect is nonlinear: below 1/3 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 negative impact on growth.

Fiscal balance is statistically significant, and influences the economic growth negatively, because large deficits impede the growth through the crowding out effects that they have on private investment. This result is consistent with endogenous growth theory and is empirically supported by Falcetti, Gsenko and Sanfey (2004), Manbrugghe (2007).

Another important variable influencing the growth of transition economies is the index that measure the overall progress made by the country and the inflation rate. Bruno and Easterly (1996), Faria, Carneiro (2001), Amber and Cardia (2002) have found a negative impact of inflation in economic growth.

4 Tax revenues performance

An important part in tax reform in transition economies was introducing the flat taxes in personal incomes, and corporate income tax. The advantages of flat tax are administrative simplicity, lowering marginal tax burden, reducing inefficiencies in economy by avoiding double taxation, promoting labor force participation.

According to Basham (2008) transition economies should grow faster, as part of a convergence process, but transition economies with flat tax system are growing more rapidly than transition economies with so called “progressive” tax rate.

Flat tax reform was introduced in South East European counties after starting the transition process. The first countries that move from progressive income tax to flat tax were Baltic countries; first

country was Estonia and Lithuania in 1994. The countries in survey mostly have adopted flat tax reform in late 2000, in a more advanced stage of their transition process.

From 10 countries under survey, flat tax was introduced in six countries. The rate of flat tax in countries that used this system, was introduced at the same level for both personal income tax and corporate income tax within the country, but varies across countries. From the date reported in following table, the highest rate is adopted in Slovak Republic 19%, followed by Romania 16% and Czech Republic 15%. The lowers rate is 10% adopted by Albania and Bulgaria and Macedonia. One reason that could explain the difference in the chosen flat rate across countries could be the time of adoption of flat tax, the growth rate and the situation of public finance on respective countries. In Slovak Republic and Romania the reform was adapted in years 2004, 2005. The growth rate in these countries in the year flat tax was applied was 5.2% and 4.2% respectively, relative to 6% in Albania and Bulgaria, and 5.3% in Macedonia. The government balance was in surplus in Bulgaria and Macedonia when they decided to adopt the flat tax (Albania has a relatively large fiscal deficit that accounted for about 3.4% of GDP), relative to fiscal deficit of about 1.2% and 2.4% of GDP in Romania and Slovak Republic.

With the flat tax introduction in Albania was aimed from the government, the development of the tax system that spur the investment and the business climate, as well as the creation of the tax system which would cause less distortion and will distribute the tax burden in equal manner[vi].

The adoption of flat tax in the following countries is not pure, because is often followed by deductions and free allowance. For example in Albania personal income tax is not a pure flat tax as it exempts the first 10,000 *lek* for incomes below 30,000 *lek*. In Slovak Republic free tax allowance is SKK 80,832, and under certain circumstances there is an annual tax bonus SKK 4,800. The exemptions that are present in all transition economies make the effective tax rate to grow as income grows. Everyone with higher income pays a higher effective tax rate than anyone lower on the income scale, this make that the rich not only pay a higher amount by also pay a higher percentage. Therefore the argument that flat tax has reduced the progressivity of tax system is not necessary supported.

Table 3: Flat Tax Reform

	Year	Personal Income Tax	Corporate Income Tax
Albania			
Flat Tax Reform	2007	10%	from January 2008, 10%
Before		tax band between 1%-20%	before 20%
Bulgaria			
Flat Tax Reform	2008	10%	10%
Before		the band was between 15%-29%	from 2005, was 15%
Croatia	N/A	*progressive tax*	20% (from 2001)
		tax band between 20%-35% (97)	35% (until 2000)
		15%, 25% and 35% (2001)	25%(until 1996)
		15%, 25%, 35% and 45% (2003)	
Czech Republic			
Flat Tax Reform	2008	15%	15%
Before			
Macedonia			
Flat Tax Reform	2007	12%	12%
	2008	reduced to 10%	reduced to 10%
Before		tax band between 15%-24%	before 15%
Hungary	N/A	*progressive tax*	16%
		tax band between 18%-36%	
Poland	N/A	*progressive tax*	19%
		tax band between 19%-40%	

Romania Flat Tax Reform Before	2005	16% tax band between 18%-40%	16% before 25%
Slovak Republic Flat Tax Reform Before	2004	19% tax band between 10%-38%	19% before 25%
Slovenia	N/A	*progressive tax* tax band between 16%-41%	22%

Source: World economic outlook

5 Value Added Tax

Another important part of fiscal reform in South East European countries have been the move from direct taxation to indirect taxation. VAT adoption makes easier to raise the revenue, by improving the efficiency of overall tax system. All the countries under survey are part of WTO organization or have signed bilateral trade agreement which have influenced negatively in budget income. In developing countries reduction of custom tariffs with an increase in VAT tax has been in center of the reform (M. Shahe Emran & Josef E. Stiglitz 2005). (Richard M. Bird & Joseph L. Rotman 2005 – If VAT could be administrated in adequate way, offers the best way to substitute the losses that come from trade liberalization). (Dag Aarnes 2004– Reduction of imported tariff as part of trade liberalization is possible to bring losses in short term in budget incomes. These losses could be eliminated through reduction of tariff exclusions in existing tax system, through excise rate for imported goods, or through consumption tax like VAT changes.

Table 4: VAT in transition economies

	VAT
Albania	20%
Bulgaria	20% there is a reduced rate of 7%
Croatia	*introduced on 1998* 0%-10%-22%
Czech Republic	19% there is a reduced rate of 9%
Macedonia	18% there is a reduced rate of 5%
Hungary	20% there is a reduced rate of 5%
Poland	22% reduced rate of 7% and 3%
Romania	19%
Slovak Republic	19%
Slovenia	20% there is a reduced rate of 8.5%

Source: IMF fiscal statistics

VAT is very important part of total tax revenue; they count for more than 30 percent of total tax income in respective counties. From the above reported data, there are not big differences between the VAT rates that the countries are applying; the range is from 18 percent to 22 percent.

The spread of informal sector in transition economies is documented at figures that vary from 40 to 60 percent of the GDP, this could be harmful for budget revenues, in the terms of workers that are not register, and losing in social insurance. Fiscal evasion is another big problem facing transition economies that heavily harm total tax collecting.

Below is done an empirical evaluation of total tax collection performance in transition economies, and are made evaluation for estimating the impact of informal economy in tax collection.

6 Evaluating tax performance

In this section it is done an empirical work that aims to evaluate the performance of tax revenue in transition economies. Tax literature analyze five sets of explanatory variables, economic development, economic structure, openness of a specific country to a foreign trade, control variables that count for general macroeconomic stability of a country, and institution development.

For econometric work are used annual data for time period, year 1992 -2007, for ten transition economies.

The model evaluated in this paper is based on the work of Gray, Lane and Varoudakis (2007).

$$\frac{T}{Y} = \alpha_i + \beta_1 LGDPP + \beta_2 Share\ of\ Ind + \beta_3 Share\ of\ agric + \beta_4 Pop\ Growth + \beta_5 Debt + \beta_6 CPI + \beta_7 Trade + \beta_8 Exp + \beta_9 Shadow \quad (1)$$

T/Y is the ration of total tax revenue to GDP, LGDPP is the logarithm of GDP per capita, Debt is the debt ratio relative to GDP, Trade is the ratio of exports and imports relative to GDP, Exp is the ratio of government expenditure relative to GDP, Shadow is the variable that try to measure the impact of tax evasion in economy. This variable is calculated by using the following equation (see Teera and Hudson 2004).

$$Log(M2) = \alpha_0 + \alpha_1 Log(GDP) + \alpha_2 Log(GDP\ per\ capita) + \alpha_3 Trend + Z_t \quad (2)$$

The residual term of above regression Z_t is the variable that counts for hidden economy. If this variable has a negative sign it implies a large hidden economy based on the characteristics of the given country.

Based on the respective literature about the determinants factors of tax performance, it is expected that GDP per capita to be positively related with tax performance because it counts for the overall level development of a country and higher the country development higher is the country capacity to pay taxes. Not only the total level of development, but also the output composition or branches of economy are important for tax performance. Agriculture sector in developing countries is represented by small farms and a large of them are subsistence, which are difficult to tax, therefore a big agriculture sector could have a negative expected impact in total tax collection. The situation is different with development of industry sector. This sector is easier to tax, therefore is expected a positive impact in total tax collection. Openness to foreign trade is also an important factor for tax performance because it is easy to tax foreign trade that take place in specific location. The countries in survey all have followed the policy of free trade and reduction of foreign trade tariffs and quotas, therefore the effect on revenue could be ambiguous (see Gupta 2008). Total debt to GDP ratio has also impact in tax performance, because the large debt needs to be financed by a large tax collection. Therefore is expected a positive relationship between the size of public debt and tax levels. Another determinant variable is the population density. The impact of this variable in tax performance it is difficult to be determined without a systematic study, as the size of population grows public expenditure on social services raises but sometimes the level of tax revenue could not raise as much as

expenditure (see Teera 2007). The variable that is used to measure the impact of shadow economy in tax performance is expected to have a negative sign because countries with large hidden economy are expected to have a lower tax performance.

On the bases of analysis for ten transition economies, the main results can be summarized as follows:

From the data reported on the following table could be said that the model has performed well, in the line with previous studies. GDP per capita, share of agriculture, and industry have the expected impact on the tax collection performance. The impact of agriculture is not statistically significant, by reflecting the fact that the weight of this sector in total production is decreased with the development of transition process.

Total government expenditure has an impact positive and statistically significant to tax collection, by confirming that lager government expenditure needs larger tax collection by the government in order to maintain the stability of fiscal balance.

The variable included for measuring the shadow economy is statistically significant, and the sign is in conformity with the economic literature. In order to increase the tax collection of the specific country, there is still an important fight from the respective government in order to reduce tax evasion.

The impact of trade openness in tax collection is negative and statistically not significant, by reflecting the fact that openness to foreign trade although have brought to increase in total trade volume have at the same time brought to important reduction of trade tariffs by influencing negatively to total tax revenue.

Population density has a positive impact in tax collection, but is not statistically significant.

Table 5: Regression Results, Dependent variable total tax to GDP ratio, fixed effect estimation
Sample for ten countries
Method: Pooled least squared

	Coefficient	*Std. Error*	*t-Statistic*	*Prob.*
GDP per capita	0.375088	1.191177	2.314888	0.0000
Share of industry	0.386296	0.222722	1.734434	0.0872
Share of agriculture	-0.043271	0.199378	-0.217033	0.8288
Population growth	0.839160	2.337161	0.359051	0.7206
External debt	-0.077936	0.034446	-2.262562	0.0267
Trade	-0.028477	0.035995	-0.791147	0.4315
Government expenditure	0.636948	0.070571	9.025699	0.0000
CPI	-0.036419	0.0400330	-0.903013	0.3696
Shadow economy	-1.063636	0.508317	-2.092465	0.0400
Country fixed effect coefficients				
Albania	2.504038			
Bulgaria	11.30149			
Croatia	8.957862			
Czech Republic	-0.546881			
Macedonia	6.963483			
Hungary	8.301460			
Poland	1.559073			
Rumania	2.176609			
Slovak Republic	8.684413			
Slovenia	6.921609			
R-Squared	0.961675	Mean depen var	38.38286	
Adjusted R squared	0.948125	S.D depend var	7.392553	
S.E. of Regression	1.683737	Sum squared resid	144.5835	
Durbin-Watson stat	1.593997			

Source: author calculation

7 Conclusion

The results generated from econometric framework are consistent with previous studies. Both government size and fiscal deficit are important factors that influence growth performance. The study has found support for negative impact on growth of government size in transition economies.

Very important parts of fiscal reform have been the tax reform in developing countries. The common trend for all the countries under survey is substantial deduction in corporate tax in all countries under survey, the introduction of flat tax in both personal income tax and corporate income tax. The deduction and free allowance in all transition economies have increased the effective tax rate with income increase, this made possible to argument in favor of not reducing the progressivity of tax system after flat tax implementation.

In tax performance of transition economies, GDP per capita, share of agriculture and share of industry have the expected impact in accordance with tax literature and previous studies. Total government expenditure has a positive impact in tax collection.

The variable that was used to measure the shadow economy is statistically significant and in accordance with economic literature. In order for the government to increase tax revenue the tax evasion should be reduced.

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[i] See Fiscal Policy and Poverty Reduction, http://info.worldbank.org/etools/docs
[ii]The Wagner's Law of increasing extension of state activity
[iii]Richard Armey curve state that in countries where all the decision are made by the government output growth is low, a mix private and government decision brings often high growth, if the government grow beyond its core functions the impact in growth is negative.
[iv] See the publication of Ministry of Finance of Albania
[v] Maastricht criteria have made a constrain for applicant countries to have a fiscal deficit of around 2 percent of GDP
[vi] See macroeconomic fiscal framework for time period 2009 -2011, www.minfin.gov.al