
ECA Countries Must Reform Public Spending And Taxes To Maintain Growth, Study Says

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August 30, 2007—High levels of public spending and steep payroll taxes are a threat to the long streak of economic growth in many of the countries of Eastern Europe and Central Asia, a new World Bank study says.

The 27 countries, which extend from the Elbe River to the Bering Sea, have enjoyed generally strong growth that has pulled nearly 60 million people out of poverty in the past decade. But to stay economically healthy, the vast, diverse region must make challenging fiscal reforms, the study says.

The study - *Fiscal Policy and Economic Growth: Lessons for Eastern Europe and Central Asia* - found that public spending in Central and Southeast Europe averaged 45 percent of gross domestic product (GDP), well above the rate in fast-growing middle-income countries in Asia and Latin America, such as Chile, Korea, and Thailand.

Total Public Sector Spending, by Country ECA, 1995-2005 [Click for an enlarged view](#) It also found that high labor taxes - paid by both the employer and employee - created a "tax wedge" as high as 45 percent, triple the amount in comparable fast-growing countries outside the region. The wedge is the difference between total labor costs and take-home pay.

Wide wedges slow growth by deterring job growth and labor force participation, the study says.

Co-editor Cheryl Gray, Director of Poverty Reduction and Economic Management in the Bank's Europe and Central Asia (ECA) region, said unfavorable demographics - an aging population and low birth rate - "exacerbate" the fiscal problems.

Gray, who wrote the overview first chapter of the book, said of the ECA countries, "Most middle-income ECA countries can't afford to spend more. Instead they need to spend more efficiently."

She said the countries of Southeast Europe "have the biggest fiscal problems" because they tend to be burdened with a combination of big government and weak governance. "That can definitely compromise growth," she said.

Pensions are one major area where "expenditure issues are acute" and will have to be examined, Gray says in her overview.

Encouraging indicators are cited

While the study says ECA countries face major fiscal challenges, Gray said there are many encouraging indicators:

"The region has been second only to Asia in economic growth rates over the past few years.

"Some countries, such as Georgia, Armenia, and Bulgaria, are making real progress in fiscal reform.

"In most of the region, there continue to be pretty good outcomes in health and education.

"In relation to the rest of the world, there is fairly equal distribution of income."

"Overall, the countries are moving in the right direction," Gray said. They've come along way in 17 years."

The World Bank has a number of programs to help the ECA countries - in education and health, infrastructure, policy reform and capacity building, among them. Bank lending to carry out assistance programs totals about \$US 4 billion annually.

10 ECA countries get 'special focus'

While the new study looks at fiscal policy and economic growth in 27 countries, it chose 10 for a "special focus" because they vary in size, wealth and geography and are dealing with a "broad range of issues facing the region." They are Albania, Armenia, Croatia, Georgia, Kyrgyz Republic, Poland, Romania, Slovak Republic, Turkey, and Ukraine.

The seven high-growth countries outside ECA that the study used for comparison were, besides Ireland and Korea, Chile, Spain, Thailand, Uganda, and Vietnam. Public spending in Croatia is more than double Thailand's, and the eight Eastern European countries that joined the European Union in 2004 spend on average three times as much on social transfers as Korea.

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