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# WB Good Governance Helps Fiscal Policy Spur Economic Growth

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New World Bank Report Recommends Spending and Tax Reforms to Enhance the Impact of Public Finance on Growth in Eastern Europe and Central Asia

BRUSSELS, July 2, 2007—Well-run governments get better results out of their budget resources, according to *Fiscal Policy and Economic Growth: Lessons for Eastern Europe and Central Asia*, released today by the World Bank. The study draws on quantitative analysis and case studies to confirm that more productive public spending, lower fiscal deficit, and greater reliance on non-distorting taxes can spur economic growth.

The report reviews trends in public spending and taxation in Eastern Europe, Turkey, and Central Asia (ECA) since the 1990s and how they compare to trends in high-growth countries elsewhere in the world.

Middle-income countries in Eastern Europe typically have bigger governments than comparator countries in Asia or Latin America because of large social transfers. Primary public spending in Croatia is more than double the size of that in Thailand, and the 8 Eastern European countries that joined the EU in 2004 spend on average three times as much on social transfers as Korea. The lower-income countries in ECA have smaller governments, closer in size to the high-growth comparators.

Once public spending exceeds about one-third of GDP, higher spending is associated with lower growth in countries with weak governance, but no such relationship exists in well-governed countries. "High levels of public spending are risky when public institutions are weak," says World Bank Country Manager and report co-editor Aristomene Varoudakis. "Money is less likely to be well-spent, fiscal deficits are more likely to emerge, and higher taxes needed to finance such spending are more likely to distort business and worker decisions."

"The biggest challenge in most countries in ECA is to increase the efficiency of public spending," emphasizes World Bank Sector Director and co-editor Cheryl Gray. "This is particularly important to enhance growth prospects and ensure that populations benefit from expenditures in health, education, pensions, and infrastructure."

The study offers policy recommendations to enhance the efficiency and effectiveness of public spending in these four sectors, drawing on experience in high-growth countries such as Chile, Korea, and Ireland. In education and health, for example, Eastern Europe achieves good results but at a high cost. Reorienting spending away from expensive vocational programs and high-cost hospital care, moving to per capita financing, and realigning cost-sharing between governments and students or patients can both help make public spending more effective and yield better results.

Investing in infrastructure can help boost economic growth if project selection is appropriate and operations and maintenance costs are adequately funded. Removing implicit subsidies, especially in power and water, can make resources available for maintenance while also making infrastructure more attractive for private investment.

Armenia, for example, has taken important steps to reduce pricing subsidies and improve collections in the power sector to ensure financial viability, while ensuring an adequate safety net for needy households.

Given aging populations, low employment ratios, and a legacy of generous social protection, pension spending in Eastern Europe tends to be much higher than in fast-growing countries elsewhere. Reforms of pension systems need to create fiscal space for growth-enhancing public spending while continuing to protect the most vulnerable. In middle-income countries, public pensions need to be further streamlined and complemented by privately-funded pillars and means-tested social assistance. In low-income countries, a universal or means-tested low-rate pension financed out of general revenues-as has recently been adopted in Georgia-may be the best option.

On the revenue side of the budget, the study focuses on two questions that are central in today's debate: (1) What are the economic impacts of the flat-rate income tax reforms sweeping through Eastern Europe? (2) How can labor taxes be reduced to stimulate employment?

"Flat-rate income tax reforms have generally had positive effects in Eastern Europe, but need to be complemented with additional steps to modernize tax administration and reduce labor taxation," says World Bank Senior Economist and co-editor Tracey Lane. The flat-rate income tax reform in Slovakia closed tax loopholes and improved compliance, and well-designed exemptions and changes in social benefits maintained the progressiveness of the overall fiscal system.

Despite income tax reforms, labor taxes are still much higher in Eastern Europe than in comparator countries and are associated with lower formal employment and growth. The key to reducing labor taxation and stimulating employment is to reform social benefits and move some financing to general revenues rather than relying on wage taxes.

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