

## **Fiscal policy and competitiveness in the countries of SEE<sup>1</sup>**

### **Introduction**

In the recent period SEE countries have recorded high GDP growth rates and the economic agents were acting in a stable macroeconomic environment with low inflation and stable exchange rate. However, the above stability was enabled by very high capital flows from developed countries through borrowing, foreign direct investment and cross-border transfers and savings due to very high interest rates in the countries of SEE. Such a large amount of capital increased the GDP growth significantly, but primarily through increased personal, investment and government spending i.e. by continuous growth of aggregate demand. Such state in almost all countries, depending on the exchange rate regime leads to strong pressure toward appreciation of the exchange rate.

Appreciated exchange rate led to increased preferences for foreign products that have been more competitive in the domestic market. Therefore, the domestic manufacturing companies faced a great challenge. However, the starting point of the problems in terms of competitiveness and the foundations of long-term growth in transition countries is the acceptance of the concept of development that had dominant position in shaping the economic systems from the 1980s. This package of programs was called Washington Consensus. It is a package of policy measures, including trade liberalization and competition, privatization of public enterprises and ensuring a stable macroeconomic environment. Such a stance was strongly contested by countries in Southeast Asia that had in the past 40 years a completely different recipe to ensure fundamentals of the long-term growth.

Shock therapy, which marked the transition processes in the countries of SEE through privatization and liberalization, has enabled the realization of chaotic systems with preconditions for the creation of market failure. Many manufacturing companies have been shut-down because they could not deal with competitiveness on the world market, and the state did not provide any support. At the same time a number of private monopolies was created, especially during the period of privatization of large systems - telecommunications, financial system, the oil industry, etc. Such privatization did not result in increased competitiveness and the welfare of society because of the monopolistic nature of these enterprises. Over the whole period in the SEE countries the ad hoc economic policy was pursued. In certain segments that resulted with negative effects of inefficient public sector, and on the other hand facilitated the realization of market failures by lack of state intervention in functional spheres. Therefore, the gap in terms of competitiveness compared to other countries that have conducted a functional economic policy is not surprising.

It should be noted, however, that Turkey and Greece, have not gone through the same process as other countries of SEE. However, these economies are under similar economic conditions. This is especially in sense that their economic system does not allow for the creation of products and services more value added as well. Therefore, the same recipes that are proposed here can be applied to these countries.

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The countries of SEE do not rank particularly well in terms of competitiveness. Part of the reasons for that lies in the institutional framework that was not able to lift up the level of competitiveness. In all of these countries there is a tendency of growth of trade balance deficit. Thus, the growth of imports is higher than the export growth which shows that the countries failed to impose their products and services at the domestic market. In addition to that they do not have products competitive enough to achieve a significant increase in exports. Besides that, it is important to point out that the structure of exports is primarily oriented to products and services with low value added. Therefore, these products consist of components with low proportion of technology.

Therefore, raising attitudes that efforts are needed to move away from the concept of market fundamentalism to the government intervention in the framework of industrial policy is not surprising. Government measures have to overcome constraints related to lack of finance, infrastructure, innovation capacity and human capital.

The problem is that the present model of development was concerned primarily on reduction of the tax burden - especially tax exemptions on corporate income tax and taxes on capital. The problem is that such measures have not achieved the goal. Rough and not selective measures allowed development of financial markets and in some states tax structure perfectly fitted to the interests of the import lobby. There were not enough incentives for technological developments and the growth of productive capacity. On the other hand, in terms of expenditure, the state sector is still too large and exerts too high burden for taxpayers and the private sector. Governments provide incentives to inefficient enterprises in which different lobbies and political elite have been installed. Such government spending was also not selective and did not reach the desired economic gains.

How can fiscal policy affect the competitiveness? The answer is in all these areas and issues that bother business sector the most. Therefore, we have to address components that are important for the interaction of fiscal policy and competitiveness. Some of those are on the revenue side, and some on the side of expenditures. These are, for example, tax rates, the quality of tax administration - or the system, the degree of corruption, etc. In the SEE countries the main source of competitiveness are low costs of the labor force. However, the competitiveness through low wages is not sustainable. A new concept of export oriented development accomplished by rising of the technological level of the society is necessary. This can be done through the functional government intervention by industrial policy supported by the fiscal policy.

New economic crisis which strongly affected SEE countries represents an opportunity for a radical reorientation of economic, and especially of fiscal policy. Sudden stop of the capital inflows led to a drop in economic growth rates through the reduction of aggregate demand, particularly by the fall in personal consumption. Thus, the imports fell, as well, and to a much greater extent than the exports. Therefore, at this moment functional and selective government intervention is necessary to overcome the consequences of the crisis and, more importantly, to restructure the entire economic system towards significant increase of competitiveness.

### **Fiscal policy and competitiveness in the countries of SEE**

All of the SEE countries do not rank well in terms of competitiveness. *The Global Competitiveness Report 2009-2010* places Turkey (rank 61) as best in the terms of

competitiveness, and than Greece (71), Croatia (72) and other countries follow. Characteristics of the factors of competitiveness in SEE countries are very similar. SEE countries have significant potential in terms of competitiveness because they are close to the EU and enjoy almost unlimited entry to the vast market. Of course, it should be taken into account that Greece is in the EU and Croatia very close to the upcoming entry. Together with the proximity to the EU market it is also important to mention the relatively cheap labor in relation to the EU labor market.

SEE countries have made progress in terms of competitiveness by market liberalization and reduction of the tax burden. However, a clear indicator of the problems related to competitiveness and basis for the long-term growth is a constant high rate of unemployment that averages 20%. In addition to that, there are numerous obstacles that prevent higher level of competitiveness. Extremely high cost of financing for example - the average interest rate spread in SEE is 7%, which is 60% more than in the CEE and more than double than in the EU. In period of economic crisis such a situation is much worse. The reason is that developed countries have reduced interest rates and in the SEE countries the interest rate increases due to credit restrictions and the termination of capital inflows. These are particular reasons why the significant measures of fiscal policy are necessary in order to overcome the crisis and allow the development of the companies in the period after crisis. The crisis itself presents the opportunity to achieve economic restructuring toward greater competitiveness and provide the foundations for achieving production that consist of more value added in the period afterwards.

Particularly big problem in the SEE countries in terms of the public sector – is the reform of the judiciary, fighting corruption, education, etc. However, we can highlight Greece, Turkey, Bulgaria, Romania and Croatia to some extent in comparison to other countries as regards competitiveness. However, some countries have outstanding issues related to the appearance of corruption (Albania, Bosnia and Herzegovina, Montenegro, Serbia), regulatory reform (Albania, Bosnia and Herzegovina, FYR Macedonia), human capital (Albania, Bosnia and Herzegovina, Serbia) and competition policy (Montenegro, Serbia).

Regarding the tax policy, SEE countries made the progress toward global competitiveness. This is visible through the nominal income tax rates that range from 9-20% but there are significant problems in the functioning of tax administration, tax compliance costs, tax evasion and legal uncertainty.

Although the SEE countries on average are cost-competitive, such a development is not sustainable in the long term. A special problem is the lack of human capital. Lack of necessary skills in labor-intensive sectors and activities marked by high growth, such as business processes and technologies exceeds 60% of the necessary capacity. This is particularly in terms of computer languages and software support. Because of the discrepancy between supply and demand for labor, SEE countries have serious problems in supporting growth in many manufacturing sectors. For example, 44% of the companies engaged in the automobile industry emphasize the lack of necessary skills as a major restriction in the expansion of business. Of course the lack of trained and educated staff is a serious obstacle to competitiveness - increased operating costs, reduced quality of products and services, etc. The institutional framework that can deal with such structural problems in the labor market is still underdeveloped and there is no cooperation between public sector institutions and business entities.

Problem related to competitiveness is linked to the strength of the public sector in the SEE countries. Fiscal policy in these countries is featured with the problem of procyclical spending. This phenomenon is linked to the short politician's horizon and thus conducting of populist policy that does not allow for a consistent competitiveness policy in the long term. Procyclical effects of economic policy are an indicator of the absence of long-term planning horizon and action in creating fundamentals of the sound economic system. The fiscal system must be formatted in a way to prevent procyclicality by installing preventive mechanisms. These are, for example, automatic stabilizers, discretionary measures and elasticity measures that anticipate the potential crisis. Only such system can provide continuous strengthening of the competitiveness. Part of the problem is in the domain of the political arena. Namely, the corrupt government claim part of the tax revenues and use it for unproductive public spending and in such way collect political rents. These rents are collected either directly (through criminal activity) by the authorities or are paid to different interest groups often settled in ethnic or religious groups. Why voters do not resist to such government? One of the possible explanations is that this is not possible due to lack of transparency. In period of economic prosperity due to the lack of transparency voters have no insight into the government financial operations. Such thesis is confirmed by the fact that more corrupt countries have more features of procyclical government policy.

Additional problem related to the previously mentioned issue of lack of transparency is corruption. All of the countries of SEE have problems related to corruption. According to the *Corruption Perceptions Index* constructed by Transparency International, all of these countries rank low. The fight against corruption is one of the weakest components in the strengthening of competitiveness in the countries of SEE. Although the institutions and regulatory framework is established, the problem arises in the implementation phase. The cases of corruption occurring within the interaction of the state administration and citizens is reduced, the problem remains in the public procurement procedure.

How to prevent procyclicality and consequences arising from that phenomenon? Emphasis must be just in dealing with the causes that lead to its manifestation. It is a lack of fiscal transparency. As for the quality of fiscal data in the countries of SEE, weaknesses can be found in almost all areas. These are weak external audit of public sector institutions, large differences in data between different institutions, lack of budgetary realism, unrealistic budgeting, widespread weaknesses in internal control and audit and unrealistic presentation of budget revenues and expenditures. Fiscal reports in SEE countries do not cover all areas of fiscal activity as well. There is also a problem related to weak law enforcement and regulation in the area of public financing, questionable and unreliable fiscal oversight and controls, the large fiscal and quasi-fiscal activities that occur outside the budget and fiscal risks undermining management, inadequate coordination between public institutions etc.

### **Measures to improve competitiveness through reforms in the fiscal system**

In SEE countries a significantly different fiscal policy in relation to developed countries has to be applied. The reason is the existence of much larger market failures. A target-oriented policy which directs public resources to promote growth of new activities, easing credit constraints, infrastructure and human capital has to be promoted.

#### ***Reform of public sector***

The cause of the weak competitiveness of SEE countries is in the wrong orientation of the government intervention that allowed the implementation of numerous state and market failures. Therefore, the basic prerequisite for the achievement of the objective of improving competitiveness is to increase productivity of the economy by reforming the public sector. Public sector in SEE economies should be reduced both in terms of government spending and government employment. It is possible to achieve higher level of productivity by informatization of the state apparatus and the installation of decision-making mechanism for consistent and planned directing of economic flows. The benefits of these measures would spillover directly through the unloading of the tax pressure and indirectly by more effective action in terms of creating a quality business environment. The whole functioning of the public sector should be focused on increasing the technological forces in society that within the existing production factors raise the production function of the society. This concept replaces the previous unsuccessful one which was based on cost competitiveness.

Raise of the level of fiscal transparency and public financial management is the prerequisite for the success of such reform. There are numerous measures that can improve the fiscal transparency level: better management of public guarantees and other possible fiscal activities that create a hidden public debt; strengthening of the public debt management; the presentation of medium term budget framework within the process of budgeting and creating fiscal forecasts, strategies and policy guidelines; more detailed analysis of fiscal risks. Other key areas of reform include strengthening of internal control of fiscal operations and increase transparency of tax and customs policy and administration, the active involvement of parliament in the budgetary process, improving the reporting of public companies, harmonization of data and better coordination of institutions of public authorities in their financial oversight responsibilities.

### *Channels of action of fiscal policy*

The most important limitation to increase the competitiveness of the SEE countries mentioned previously in the text are credit restrictions, underdeveloped infrastructure, lack of social capital, poor technology development, and insufficient capacity in terms of human capital. Therefore, functional and selective interventions by the means and instruments of fiscal policy must be carried out to strengthen these pillars of competitiveness.

#### *Credit limitations*

There are many instruments in scope of fiscal policy that can mitigate the problem of credit constraints of the companies. A government may use loans or grants and tax incentives. There are numerous instruments both on the side of revenues and expenditures. The financial burden can be reduced by promoting liberal regulations regarding the execution of different models of public-private partnership. The key is in focusing regulation toward higher use of private capital in areas that are defined as strategic to the industrial policy.

All of the OECD countries provide a mix of direct, indirect measures, and measures of public-private partnerships to support private innovation activities. However, it should be pointed out that in recent period the direct support in form of grants and subsidies is far less used than the indirect measures. However, SEE countries face significant credit constraints and it is therefore desirable to maintain strong financial support. Indirect tax measures are mostly given in the form of tax credits and tax allowances. Stimulation of public-private partnerships can also contribute to innovation, cost savings and growth and competitiveness.

### *Strengthening the infrastructure capacity*

Investment activities in some countries of SEE in the previous period were significant. However, these activities were often accompanied by populist conditioned decisions about investments. Thus, there was no planning and selection of priority infrastructure in terms of strengthening the competitive ability. It is well known that infrastructure affects the private sector by reducing production costs and increasing productivity but without proper planning these effects can be minimized. Large infrastructure investment burdens the government budgets due to the existence of significant corruption. Due to the corruption, significant resources are lost through more expensive projects and installation of investments that were in benefit of certain lobby groups. In addition, investments were not directed towards the formation of industrial clusters, which stems from the lack of a consistent development strategy. Therefore, above all, it is necessary to increase the quality of decision-making within the public sector in order to invest in infrastructure that achieves the highest multiplicative effects and raises the productivity of the private sector.

### *Strengthening of the social capital*

It is an effort to establish long-term coordination between the state and major economic entities. Such activities are the promotion of trade and exports, promotion of national brands and sponsorship of cooperation between private and public institutions. Such forms of cooperation can be institutionalized through a variety of export-oriented state institutions (financial and non-financial).

### *Strengthening innovation capacities*

Innovation capacities can be raised by a form of direct spending on research and development of public or quasi-public institutions. There are also indirect forms such as tax subsidies and protection of intellectual property rights. These interventions are widely used in developed countries while some developing countries have gone much further. In China, for example, the state has the most important role in the development of high-tech industry - as a result, China became the world's most important exporter of information and telecommunications goods. The expenditures for research and development in the countries of SEE should be raised in order to reach the level of developed countries. However, resources should be oriented primarily to applied research due to limited financial capabilities of small SEE countries. In relation to the EU countries, SEE countries significantly lag behind in terms of investments in research and development. And this holds both in relative and (in percentage of GDP) absolute terms (expenditure per capita). There is no single path to change such undesirable circumstances but it is clear that the government intervention is a key factor to overcome these differences by ensuring the business and legal environment and creating incentives to innovate both in private and public entities.

### *Investments in human capital*

Recent studies indicate that fundamentals of economic growth are based on education and strengthening the competitiveness and quality of the public sector. New theory of economic growth ties productivity growth and innovation. Economic and fiscal policy in SEE countries is still based on the rejected liberal model of development and therefore can not provide competitiveness on the global market.

Investments in human capital are the basic factor that allows countries to structure the industry towards new products and services which are characterized by higher value added. Such investments must follow the primary objectives of industrial policy in order to facilitate match of structure of the industry and educational skills of the workforce, and prevent potential structural unemployment. Structural unemployment is one of the most important problems that occur in the SEE countries, as the consequence of lack of consistent and comprehensive industrial and labor market strategy.

#### *Interdependence of fiscal and industrial policy*

Fiscal policy has to support the industrial policy under the framework of set of coordinated measures which will include investment in education, reduction of government costs and increased efficiency of the government by establishing the mechanisms for planning, financing of strategically important areas, strengthening of the fiscal transparency in order to prevent a potential government failures, specific and timely interventions in accordance with the specific needs of individual national economies.

The objectives of the economic policy of SEE economies should be consistent with the objectives of the EU stated in the Lisbon agenda. These goals strive for the creation of Europe as an attractive place to invest and work - reducing administrative costs, investment in infrastructure, protection of intellectual property rights, harmonization of tax rates and especially the consolidation of corporate income tax. These goals are further in promoting knowledge and innovation - the goal is 3% of GDP that goes to investment in research and development, promoting the innovation pool, strengthening public-private partnership, environmental-oriented production, and finally, creating better conditions on the labor market.

Present lack of state support makes these goals for SEE countries hard to achieve. However, by improving the structure of public spending and reforming the tax system part of the existing resources can be more efficiently used. The tax system should be in function of economic development and not in the direction of satisfying the fiscal appetites. In addition, because of the proximity of these countries and other common factors, stronger regional integration in the context of economic development of SEE countries is needed in order to overcome current problems related to competitiveness by enabling much larger market and development of domestic industries.