

FISCAL POLICY AND POVERTY REDUCTION

This material serves as a basis for promoting a debate on the role of fiscal policies for poverty reduction.

The main issues that need to be addressed and on which debate may be focused are:

Budget revenues

1. Economic growth and generation of income

Fiscal policy is destined to play a key role in the prospective economic growth. This is due not simply to the fact that fiscal situation is a major component that determines the macroeconomic stability. The essential argument consists in the fact that the capacity of the Albanian economy to generate revenues remains highly limited. Although in terms of economic growth performance, Albania has developed relatively well compared to the economies of the region, data show that the budget revenues are at a lower level compared to the GDP.

At the end of 2001, budget revenues in relation to the GDP for some of the countries of the region are the following:

<i>Albania</i>	<i>23 percent;</i>
<i>Romania</i>	<i>31.5 percen;</i>
<i>FYROM</i>	<i>35.3 përcent;</i>
<i>Bulgaria</i>	<i>40 përcent;</i>

Another major difference in this 'gap' is also the composition of revenues. For Albania customs revenues continue to play an important role in the total revenues in relation to the other countries with which it compares:

At the end of 2001, customs revenues in relation to the GDP and the total budget revenues for some of the countries of the region are the following:

<i>Albania</i>	<i>2.2%</i>	<i>9.4%</i>
<i>FYROM</i>	<i>4.0%</i>	<i>11.2%</i>
<i>Romania</i>	<i>1.1%</i>	<i>3.5%</i>
<i>Bulgaria</i>	<i>0.9%</i>	<i>2.2%</i>

The implications of these developments are pointed out in Albania's perspective of the reduction of customs tariffs¹ both in its perspective of free trade with the countries of the region, the commitments stemming WTO membership and in the process of integration in the economic and trade structures of the EU.

From this analysis, it results that it is necessary to examine the alternatives for the increase of the revenues.

2. An overview of the structure of incomes and possible sources of growth

After analyzing the income structure at the end of 2001 according to the main categories we see:

	Total of revenues from taxes, % of GDP*	Personal income taxes	Income taxes	Social Insurance Contributions	Goods and Services
Albania	19.3	1.1	1.7	3.8	10.8
Bulgaria	30.8	4.7	3.3	8.0	12.8
FYROM	25.0	3.9	0.8	9.2	11.1
Rumania	30.1	4.1	3.0	9.1	10.0
Hungari	38.7	6.5	2.2	13.9	15.1
Italy	42.7	10.7	3.0	12.2	13.0

(*note: the total of tax income in the above table includes also the social insurance contributions)

From the analysis of the tendencies noted as of 1997, we note the following trends:

- Overall, the budget revenues from taxes have grown from 16.6% to 19.3 % of the GDP; however, their level is much lower than that of the other countries surveyed in this analysis (obviously this ratio is much lower compared to the economies of the developed countries).
- Indirect taxes account for the main share of this category of budget revenues: VAT (30.8 per cent of the total tax income), customs revenues (9.4 percent) and from excises (7 percent). The growth of revenues in this category of income has come particularly from the increase of VAT revenues, mainly from the increase of its rate from 12 percent to 20 percent. Even though this is a slight tendency, the fact is that the revenues from the customs are declining, while the revenues from the excises have grown compared to 1997 and remain almost constant as of 1998. The VAT rate for some countries is: Bulgaria – 20%; Croatia – 22%; FYROM – 19%, (5% farming products, energy, and transport); Romania – 19% (0% for goods and investments in the free zones).
- The tax on the companies' revenues accounts for 7.6 percent of the total tax income, as against 4.6 percent in 1998. The rate of the profit tax² that is applied in Albania has been reduced from 30 percent in 2001 to 25 percent. This rate is 15 percent in FYROM, 18 percent in Hungary, 25 percent in Romania, 20 percent in Croatia, and etc.
- Personal income tax has marked an increase of about 1 percent of the total income in 97-98 to 4.6 percent in 2001. Albania applies a progressive system of personal income tax system. In other countries, this tariff varies from 20 percent in Yugoslavia to 35 percent in Hungary and FYROM. As of 1998, Albania began to apply taxes over the revenues created from the investments of the depositors (revenues from bank interest rates) and capital investments (over dividends).
- Revenues from social and health insurances make up 16.6 percent of the total income (or 3.8 percent of the GDP), marking a slight increase during all the period from 1996. The rates of social insurance contributions are much higher than the personal income taxes; on an average, the employers and the employees pay 35-45 percent of the salary fund in contributions. Up to the end of 2000, these rates were: 44.2 percent for Albania (34.2 + 10); 39.7 percent for Bulgaria (31.9 + 7.8); 30.6 percent for FYROM; up to 48.5 percent for Hungary (36 + 12.5).
- An important source of funding for our country are also the non-tax revenues which are composed

almost entirely of the transfer profit of the Bank of Albania. At the end of 2001, this category of income ranks third in terms of its size (after VAT and the revenues from customs taxes) with 8.1 percent of the total budget revenues, or 1.85 percent of the GDP. This category of income, which results mainly from the high bank interest rates, will tend to go gradually down (0.5 percent of the GDP in the developed countries). For its part it accounts for the reduction of an important category of government expenditures, the payment of interests, which amounted to 4 percent of GDP by the end of 2001.

The above facts also bring out some issues that may be discussed:

- The level of taxes or contributions in all the categories of income seem to be within the possible limits.
- The level of consumption taxes (regressive taxes which weigh more heavily on the poor strata) are not differentiated: would it be plausible to reconsider a reduction of this tax or imposing a two-tier VAT?
- Macroeconomic consolidation of the country and the integration trade processes will account for the flow out of a considerable share of budget revenues (tax and non tax).
- *Under these conditions, what would be the ways of increasing the level of budget revenues to cope with the growing needs for government expenditures for the social and physical infrastructure of the country?*

3. Informal Economy and Budget Revenues

A major hurdle to the increase of budget revenues is the spread of informal economy. In various documents, its figures vary from 40 to 60 percent of the GDP.

It must be pointed out that so far there is no complete study of the informal economy in all its dimensions. Studies on the informal labor market offer a figure which is approximately 25 percent, which is relatively considerable in terms of the dimensions of the total labor market. Bearing in mind that these assessments describe only the informal employment and that it is much more difficult to make a comprehensive assessment of it because of the under reporting of the level of wages of the workers employed in this system, we might say that this phenomenon must be more widely spread. **Hence, it is also an important source for the increase of revenues from social insurance, which have drawn a considerable part of state transfers (about 2% of GDP) (?)** These funds might be reallocated to other fields of social sector and social protection.

Fiscal evasion (avoidance by private entities of paying taxes and customs dues) has, apart from having major implications in upsetting the economic structure of the country and deforming the market, also created an incalculable outflow for the country's finances. In this aspect, too, there are no accurate assessments about the level of tax evasion. In addition to anecdotic estimates found in the media, no serious assessments have been yet made. Some estimates made by some researchers³ stress that **figure of fiscal evasion can be as high as about \$ 500 million a year**, a figure which is about 50% of the total revenues of the state budget.

As can be seen from such data, the possibility for increasing the supplementary revenues to the budget from the reduction/elimination of the informal economy is a major source, and, given the current tax rates, probably the only one.

4. Administrative aspects of the tax system

With respect to the legislative aspect, efforts have been focused on the establishment of a legal fiscal network of advanced standards, whereas institutional reforms to establish a modern fiscal⁴ and transparent administration have turned out to be very difficult.

This is why there has been no equality among entities in the payment of taxes. The media have given plenty of examples of firms, which have been often well known, that continue to report losses for years and avoiding to pay taxes.

- Tax inspectors do not have the necessary authority to establish equality among tax entities and have not developed the necessary mechanisms to ensure this equality, also for the registered firms, while the number of unregistered firms that exercise economic activity is still very high. Although it is hard to quantify it in figures, the fact that the media continue to publish reports on the actions (though sporadic) of the tax police and their sequestering of the assets of such firms are evidence to the fact that we do not yet have developed sustainable mechanisms of control. On the other hand, the advance payment of profit taxes by the companies seems to be a procedure that has often turned out to be discriminatory. The companies themselves complain that the payment of taxes is more often based on the plan of budget revenues and not on the real indicators of the profitability of their activity. The reimbursement of the VAT still remains a chronic problem, placing the activity of various subjects in difficulties regarding their liquidities.
- The system of auditing the accounting balances has constantly been a source of abuses, creating difficulties for the tax authorities. Auditing by the tax authorities cannot cover all the registered companies. On the other hand, the responsibility of the accounting experts in certifying the balance sheets of the companies is very undeveloped;
- The customs procedures leave great room for subjectivism by the customs agents⁵, which incurs supplementary costs to businesses.

In general, the climate of cooperation among these tax and customs institutions and businesses continues to remain distrustful. On the one hand, entities complain that they are prevented in their activity by the fiscal authorities through subjective, arbitrary and discriminatory procedures and on the other, many companies carry out economic activities outside the fiscal system.

Budget Expenditures

1. General overview of government expenditures

The low level of budget revenues and the considerable increase of the public debt have brought pressure to bear on the fiscal adjustment and have had an impact on the continuous reduction of government expenditures. In real terms, the increase of these expenditures began only after year 2000.

Just like the budget revenues, the expenditures also stand below the average level of the economies in transition. This has dictated the need for a reduction of expenses in all the categories, of which the only item that has grown is the payment of interests (25.3 percent of budget expenditures in 1998, dropping to 12.7 percent in 2001), due to the high bank interest rates.

From the point of view of a more effective and strategic management of government expenditures, as of 2001 the Medium-Term Budget Program (MTBP) began to be applied. This document serves as an important orientation for preserving fiscal discipline, prioritizing public expenditures, and linking them better

with the government policies and encouraging greater technical effectiveness in the allocation and use of financial resources.

2. Structure of Expenditures

	1998	1999	2000	2001
Total expenditures, % GDP	30.8	32.7	31.6	31.5
Main categories of expenditures, in relation to total expenditures (% of GDP)				
I. Current expenditures	82.9 (25.5)	79.1 (25.9)	78.1 (24.7)	75.7 (23.8)
1. Personnel	20 (6.2)	18.8 (6.2)	19.5 (6.2)	22.1 (7)
2. Interests	25.3 (7.8)	21.1 (6.9)	17.3 (5.5)	12.7 (4)
3 Operational & maintenance expenditures	13.1 (4)	12.1 (4)	11.3 (3.6)	8.5 (2.7)
4. Subsidies and social insurancee	17.2 (5.3)	20.5 (6.7)	21.9 (6.9)	23.4 (7.4)
II. Capital expenses	17.1 (5.3)	20.6 (6.7)	21.3 (6.7)	23.3 (7.4)

(Ministry of Finances⁶, 2001)

- *Personnel Expenses*

As a result of the reform in the public administration, employment in the public service has been constantly reduced. Hence the expenses for salaries have marked a decline until the end of 2000, although if we see the analysis of figures, we will note that pays have increased (in nominal terms) by about 50 percent in 2000, as against 1996. The growth after year 2000 in this category is linked, besides the reform in the increase of salaries, (with more marked increases in the sectors of defence, justice and police) also with the reclassification of "boneses" (about 0.5 percent of the GDP) which in the past was included in the operational and maintenance expenses.

- Although in the budget projections, the increase of salaries in the sectors of health and education, both considered priority sectors for the reduction of poverty, have been higher than in the other sectors, the pace of their growth must be higher. Compared to the pays in the other sectors of civil service, the pays in these two sectors continue to be lower. The levels of salaries in these sectors have been identified by the GPRS as critical elements among the causes that have led to the decline in the educational level and the lack of medical treatment, particularly in the rural zones.

- *Operational and Maintenance Expenses.*

Even though expenses for the categories of the MTBP have been forecast to grow (with the rate of GDP growth), their levels are considered insufficient to cope with the maintenance of infrastructure due to the imbalance between the funds of salaries and the funds of goods and services. In most cases, the operational and maintenance expenses account for less than 15 percent of the current expenses.

Hence, the physical infrastructure is not in good condition and is deteriorating rapidly. The quality of

services is influenced by the lack of equipment and the necessary basic materials.

This is becoming a critical issue also in terms of maintaining physical infrastructure renovated with the donors' funds. For this reason, the MTBP envisions an increase of up to 3.9 percent in 2004, which will address mainly the sectors of education, health, and physical infrastructure.

- *Subsidies and social protection transfers*

Subsidies have covered textbooks, railway and urban transport, the drainage system (in agriculture), and the programs for the promotion of employment (for employers). Although subsidies have accounted for only 0.4 percent of the GDP in 1996, due to the energy crisis (subsidies for the imported energy price) they amounted to 1.2 percent of GDP in 2001.

Even though the measures taken by the Albanian Energy Corporation [KESH] are believed to ameliorate the situation of receivables from the debtors, the public utilities enterprises, (particularly the water enterprise) are debtors to KESH. This may result in an increase of subsidies for them. In general, this category of expenses is expected to be reduced up to 0.3 percent of the GDP up to 2004.

The social protection transfers are linked mainly with the pension schemes. The financial sustainability of KESH has been depending for a long time mostly on the fiscal transfers. The number of contributors is very low, and the number of contributors of the private farming sector accounts for less than 20 percent of the total number of contributors in the system. The two measures taken recently by the government (the increase of the pension age and the reduction of the measure of contributions, combined with the increase of the threshold of salary for the calculation of the pension contribution are expected to yield results in the improvement of the performance of the insurance scheme. These measures together with the promotion of participation in the voluntary insurance schemes are expected to reduce the share of budget transfers to about 1.4 percent of the GDP up to the end of 2004 (as against 2 percent it is at present).

There is room for improvement also to better target the families that benefit from the economic assistance. The best check systems and their gradual decentralization and transfer to the local authorities, have made it possible to reduce the number of the beneficiary families and increase the amount of benefits for the strata that are really in need.

- *Public investments*

Have undergone a sustainable increase, which accounted for 7.4 percent in 2001. A continuous problem remains the inclusion of foreign funding in the budget system. It is estimated⁷ that about 30 percent of the foreign financing remain unreported, which creates problems regarding their financial arrangement, the postponement of the projects (due to the non allocation of the funds as local share, as compensation for the VAT, etc.) and the lack of transparency.

Nevertheless, the main problems in public investments are:

- Lack of professional capacities in the line ministries for the planning and budgeting of projects;
- The inherited practices of the division of budgets on an annual basis and not according to the total cost of projects;
- :Lack of consolidated information for projects with foreign and domestic funding;
- Investment projects do not have clear and transparent cost procedures and techniques of calculations. Therefore, there are possibilities for reducing the costs of individual projects and increasing the number of projects.

- The mechanisms of the monitoring of projects, particularly of the infrastructure projects, remain very weak, something that not rarely has created problems in the weak quality of the work in the funded projects, delays and postponement of the implementation of the projects within the set deadlines, and demands for supplementary funds for various reasons, etc.

These weaknesses were noted also during the process for the drafting of the GPRS, where in general the line ministers were unable to provide the budget implications for the measures proposed as government actions included in the program.

From a sectoral point of view, it is important to identify the expenses made for education, health, and social protection.

The expenses for education, which account for approximately 3.2 percent of the GDP, are lower than those in countries with income under the average level (4.8 percent of the GDP). In health, public expenditures are calculated to be about 2 percent of the GDP, or 2/3 of this level in the countries with income levels below average. The low level of public expenditures is reflected also in the deterioration of the public services in both sectors, having a direct impact on the growing level of poverty (measured with these indicators).

Considered in the GPRS as an important orientation for poverty reduction, the budget program has given priority to the increase of expenditures in these sectors, programmed to become respectively 3.7 and 3.2 percent of the GDP by 2004.

Fiscal decentralization

The process of fiscal decentralization and the shifting of responsibilities to the local authorities is a new phenomenon that has developed after 1999. The revenues of the local authorities accounted for only 0.35 percent of the GDP in 2001 and were raised mainly by the central fiscal authorities and were given to local authorities in the form of unconditional grants.

Some local taxes are at present in the process of the transition to the local authorities to be collected by them as taxes on small businesses, on the farming land (expected to be approved in the course of this year). It is believed that the shifting of this function to the local authorities will have a positive impact on revenues. The main argument in favor of this is a higher level of knowledge by local businesses and the more transparent flow of information. This is a process that also has a cost. Is it therefore not necessary to make more accurate and better studied assessments of these expected measures? At any rate, the transition of these functions should be done parallel with the training of the future local administration to be capable of taking over these responsibilities.

The main economic sources for the exercise of their exclusive functions (maintenance of local roads, lighting of roads and public services, urban planning, transport, collection and processing of waste, water supply, cultural and sport activities and the services of local economic growth) have been ensured mainly through the allocation of funds from the central budget. The problems manifested in this respect have to do with undeveloped local capacities to forecast the financial needs based on the real needs.

Another aspect of decentralization includes also the development of common functions between local and central authorities in the field of education, health, social protection, public order, and protection of environment.

The development of these functions can be done mainly through sectoral initiatives and the line ministries should cooperate with the local authorities to develop joint programs.

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¹ However some studies prove the existence of a positive correlation between the reduction of customs tariffs and customs budgetary revenues. See for eg. Ahmet Mancellari, Hasan Mytkolli, 2002, "Fiscal Constraint and Trade Liberalization – the Case of Albania", Bamberg University. Public Economic Series, Volume I. Nevertheless, the positive values of the correlation that derives from the regression analysis in the model that these authors have built, may be interpreted more as a reduction of the customs evasion because of the reduction of the level of tariffs.

² See, Jean Tesche, 2001 "The Role of State in South East Europe – Fiscal Issues", draft-paper.

³ See for eg. a quote from "Albanian Economic Review" no.1, which refers to an existing study but it does not provide the methodology of measurement.

⁴ This part may be treated and discussed in a more detailed manner in another paper "Governance and Institutions" for this round of consultations.

⁵ See for eg. evidence provided by the study "Obstacles to Trade, Growth, Investment and Competitiveness", Balkan Network, September 2001 (www.balkannetwork.org).

⁶ The following analysis is based on the data and problems identified by MTEF 2002-2004. This document is presently in an update process.

⁷ See: Ministry of Finance, MTEF/2002-2004, June 2001.