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Are the Fiscal Rules in Albania Reducing the Fiscal Deficit?

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Abstract: Countries face various challenges that force governments to increase government spending to mitigate the effects on the citizens, thus increasing the fiscal deficit. The question raised is whether the fiscal rules are reducing the fiscal deficit in Albania. This paper aims to throw some light on this matter, supporting it empirically which is the gap in the existing literature. The data covering the period 2000-2022 were obtained from the Ministry of Finance and Economy of Albania, INSTAT, and the World Bank. EViews 7 and the method of LS were used for the empirical analysis. Three regressions were performed to specifically see the impact of fiscal rules (dummy variable), economic growth, and public debt on the fiscal deficit. The results indicate a negative relationship between fiscal rules and economic growth to the fiscal deficit, and a positive relationship between public debt to the fiscal deficit, however, in each case, the relationship is statistically insignificant. The government can rely on these results to ensure the appropriate mechanisms to receive the benefits of fiscal rules, while other academics can deepen the analysis by evaluating the impact of the fiscal rule strength index in Albania and in the region as well.

Keywords: Empirical Evidence; Debt; Economic Growth; Government; Public Finance

JEL Classification: E62; H68; O47

1. Introduction

One of the main objectives of every government is the long-term sustainability of public finances, through which it can offer better services to citizens. Among the main parameters to ensure this sustainability are public debt, fiscal deficit, and primary balance. In this context, in order to ensure a sustainable reduction of fiscal deficit and public debt, the Albanian Government has included a series of fiscal rules and principles in the revised organic budget law (OBL) in 2016. These rules and principles are intended to maintain the level of fiscal deficit and public debt at an appropriate level in the context of the Albanian economy, as well as the intensification of policy efforts for fiscal consolidation during economic growth in order to build more obstacles for periods of slowdown.

More efforts have been made to enforce the fiscal rules and principles established in the OBL. The follow-up and monitoring of fiscal rules were also included in the public finance management strategy action plan, as one of the main strategic documents in the country with the objective of achieving a well-balanced and sustainable budget and a reduced public debt ratio. In addition, dedicated sections have been added to the 2017 budget consolidated report and the fiscal framework for 2018-2020 to explain how these two Acts fully comply with the principles and the corresponding fiscal rules outlined in OBL.

According to an IMF study (Eyraud et al. 2018), the complexity of fiscal rules has increased over the years, raising doubts about their ability to guide policies. Meanwhile, Mathieu and Sterdyniak (2013)

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concluded that fiscal policy rules were not useful during the crisis. On the other hand, the fiscal deficit is often used as a key benchmark to determine the overall health of an economy. In this context, the paper aims to empirically investigate the relationship between the fiscal rules in force in Albania, economic growth, and the public debt to the fiscal deficit. Three hypotheses will be tested:

Hypothesis 1. Fiscal rules have a negative impact on the fiscal deficit

Hypothesis 2. Economic growth has a negative impact on the fiscal deficit

Hypothesis 3. The public debt has a positive impact on the fiscal deficit

The paper will be organized into five sections. Section 2 will present the findings of several authors on the relationship of the variables taken into analysis. In the third section, the methodology used for hypothesis testing and the description of the variables and their trend for the period 2000-2022 will be given. The fourth section presents the empirical results, while the last section summarizes the conclusions of the paper, as well as recommendations and possible implications for interest groups.

2. Literature Review

Numerous studies have analyzed the relationship and impact of different factors on the fiscal deficit (balance). In this section, some of the findings on the relationship between the indicators (variables) obtained in this study, such as the fiscal deficit, fiscal rules, economic growth, and public debt, will be presented. Regarding the impact of fiscal rules on the fiscal deficit, authors Badinger and Reuter (2017) found that countries with stricter fiscal rules have lower deficits. According to Heinemann et al. (2017), fiscal rules have a positive impact on fiscal deficits, however, it is difficult to identify systematic differences in the fiscal behavior of countries with and without rules, taking into account the characteristics of countries. Meanwhile, fiscal debt and fiscal balance rules improve fiscal balances without resources, especially in oil-exporting countries. Fiscal rules reduce the fiscal deficit, thus improving fiscal performance (Apeti et al. (2023)). Gootjes and Haan (2022) found that fiscal rules significantly improve budget performance. The authors Caselli and Reynaud (2019) showed that there is a statistically significant positive relationship between the index of fiscal rules and the fiscal balance, as well as fiscal rules, which are related to lower deficits. Also, in an analysis of over 140 countries during the period 1985-2015, they found that fiscal deficits averaged 2.1 percent of GDP in the absence of fiscal rules versus 1.7 percent of GDP in the presence of fiscal rules. In terms of policy implications, Tapsoba (2012) suggests that the introduction of a fiscal rules-based framework is a reliable tool for governments in developing countries to counter the absence of fiscal rules. Simsek and Bekar (2008) opined that although the implementation of the fiscal rule established by the Turkish government improved the balance of public finances together with the rate of inflation, it negatively affected private investments, causing a decrease in them, as well as an increase in the rate of long-term unemployment. Grosse-Steffen et al. (2021) affirmed that tight fiscal rules create fiscal space in good times to cover fiscal deficit spending in bad times. While Blesse et al. (2023) revealed that fiscal rules implemented to maintain fiscal sustainability have an impact on limiting public deficits and public debt. Eyraud et al. (2018) claimed that some rules improve fiscal performance, while some rules may have the opposite effect, which means that rules do not have a universal effect on fiscal performance. According to Larch et al. (2020), drafting fiscal rules is important, but not as much as their compliance. Golinelli and Momigliano (2006) concluded that fiscal rules in European countries have a significant impact on the behavior of countries with high deficits. While the authors Marneffe et al. (2010) have investigated the impact of the existing framework of fiscal rules in the Eurozone and claim that it has a non-negligible impact on the fiscal balance.

When referring to studies on the relationship between fiscal balance and economic growth, most of them support a positive relationship between them. Easterly and Rebelo (1993) in their study concluded that there is a strong relationship between the level of development and the fiscal structure. The authors found that in poor countries, revenues from international trade taxes are more important, while for developed countries, income taxes are more important. Meanwhile, according to Nabieu et al. (2021), there is a positive relationship between fiscal rules and fiscal performance and a negative relationship with economic growth. Ezeabasili et al. (2012) and Kesavarajah (2017) also found a negative relationship between economic growth and fiscal deficit. While Roy and Berg (2009) concluded that the relationship between the budget deficit and economic growth is unclear. Many studies have been done to investigate the relationship between public debt and fiscal balance. Folorunso and Falade (2013) found a positive relationship between the two variables, where a 1% increase in public debt leads to a 1.85% increase in the fiscal balance. In addition, they confirmed the bi-directional relationship between the fiscal balance and the public debt, while showing that the internal debt had the greatest impact on the fiscal deficit compared to the external debt. According to Tanzi and Blejer (1988), the high fiscal balance led to an increase in public debt both in developed countries and in developing countries.

3. Data and Methodology

This paper aims to shed light on the empirical impact of the fiscal rules established in 2016 in the OBL of Albania on fiscal deficit. The data covering the period 2000-2022 are obtained from the Ministry of Finance and Economy of Albania, INSTAT, and the World Bank. In order to get a more accurate assessment, economic growth and the public debt to GDP ratio were also included in the analysis, as two of the variables that have significant weight in the fiscal deficit. In the following, a brief description of the variables, as well as the empirical model and limitations will be presented.

3.1. Data and Measurement

Four variables were analyzed to test the hypotheses, where the fiscal deficit is the dependent variable, while fiscal rules, economic growth, and the public debt to GDP ratio are the independent variables.

Fiscal deficit (balance) - The fiscal balance or the general balance of the government can result in a surplus if government revenues exceed government expenditures, and with a deficit if government expenditures exceed government revenues, or zero if government revenues are equal to government expenditures in a fiscal year. During the reviewed period, it is evident that the balance results in a budget deficit in the case of Albania, i.e. expenditures are not covered by government revenues. For the purpose of the analysis, the fiscal deficit to GDP ratio is taken as a more effective indicator of public finance management. Based on the data for the period 2000-2022, the fiscal deficit is characterized by a declining trend during the period 2000-2006, mainly stimulated by economic growth. While during 2008-2009 the fiscal deficit significantly increased from 3.5% in 2007 to 7% in 2009 due to the negative effects of the global financial crisis. After this period, the fiscal deficit is characterized by a declining trend with small fluctuations, marking the lowest level in 2018 with 1.6% of GDP. Meanwhile, in 2020 there was a drastic increase reaching 6.7% of GDP due to the earthquakes of 2019 and the Covid-19 pandemic at the beginning of 2020 that hit the country's economy in a very short period of time.

Fiscal rules – The first and only fiscal rule in Albania was established in the OBL of 2008 'Total public debt, including guarantees, should not exceed the limit of 60 percent of the Gross Domestic Product'. Meanwhile, in 2013, this rule was reformulated and called the "golden rule". According to the rewritten rule, borrowing for current expenses was prohibited and current expenses had to be covered by income while borrowing would only be used to finance capital investments. In 2016, the Government of Albania established some new fiscal principles and rules, to ensure stability and sustainability of the public debt. Specifically, the following established fiscal principles and rules as formulated in Article 4/1 in OBL are presented in the following box:

The budget is planned and executed, taking into consideration the below principles:

1. Public debt sustainability, which consists in:

a. In each annual budget law, original or revised, the ratio of public debt to GDP shall be planned lower than the estimated level of the previous year, until the debt level reaches and stays under the threshold of 45% of GDP.

b. Exception from point a) rule is made only in the exceptional cases and circumstances stipulated in article 4/4 of this law.

c. Nominal value of GDP in ALL which is used to calculate the ratio of public debt to GDP for projected years and for the previous year, cannot be higher than the one forecasted or estimated in the IMF's World Economic Outlook report, the latest published in the time when the annual budget proposal is submitted for approval to the Assembly. This fact is clearly documented in the explanatory note of the annual budget proposal.

d. Each planned budget year includes a specific contingency of no less than 0.7% of total budget expenditure, to compensate for potential risks from fluctuation of exchange rates or interest rates, affecting the debt level.

e. In each original budget law, as well as in the medium-term budget planning, when the real growth of GDP, forecasted in the respective IMF's World Economic Outlook Report, is at least 5 percent, then the overall deficit cannot be higher than 2 percent of GDP, except for the cases of exceptional circumstances, stipulated in the letters a, b and c of the Article 4/4 of this law.

f. During the budget monitoring phases of the actual budget, if due to eventual revisions of GDP estimations or forecasts made by the specific institutions or due to changes in the exchange rates used for the estimation of public debt actual stock, would result that the ratio of public debt to GDP is not lower than the previous year, it shall be compensated in the budget planning process of upcoming years.

2. Revenues from privatization are not part of the budget planning. In the case of their collection, they are used not less than 50% for the public debt reduction, and the remaining part for investments.

3. Fiscal law amendments, which affect budget revenues, happen once per year, not later than three months before the beginning of the new fiscal year. Fiscal laws are preliminarily consulted with business representatives and other interest groups, in the due structures created for this purpose.

The annual amount of the budget deficit cannot exceed the annual amount of capital expenditure, approved each year in the budget law.

Referring to the 2016 and 2017 Albanian Public Finance Management monitoring reports, overly optimistic estimates were one of the major policy biases identified in the past. The established OBL fiscal rules in 2016, first reduced this bias and then set the public debt on a deterministic downward trajectory. By the end of 2016, the forecasted nominal GDP was lower than the forecasted nominal GDP in the World Economic Outlook, and the Debt to GDP ratio for 2016 was lower than in 2015. The 2017 Annual Budget's formulation took into account a number of significant initiatives, such as expanding and streamlining the tax base, lowering the cost of structural changes, and other measures to further lower the public debt to GDP ratio. The Ministry of Finance and Economy is obliged to report to the Parliament and the Council of Ministers on the implementation of the fiscal rules established in the OBL to ensure that the fiscal consolidation is on the right track and the debt is reduced according to the path provided for in the same Law.

These rules are incorporated for follow-up in the Public Finance Management strategy in order to reinforce and guarantee their adherence. On the other hand, the Ministry of Finance and Economy of Albania prepares the Fiscal Macroeconomic Framework each year, in which the government's objectives are defined in relation to the key fiscal policy indicators, including the general fiscal deficit (balance), borrowing, public debt, primary, and current fiscal balance. The ceilings for Medium-Term Budget Planning are also established at the ministry level based on this framework. Additionally, a dedicated section has also been included for the compliance/fulfillment of these rules.

Although these fiscal rules and principles were followed during the preparation of the macroeconomic and fiscal framework, the actual public debt was not in each case lower than the previous year. The fiscal rule is a dummy variable taking the value 1 when fiscal rules were in force and value 0 when fiscal rules were not. The figure below shows the trend of the fiscal deficit and the presence or absence of fiscal rules.

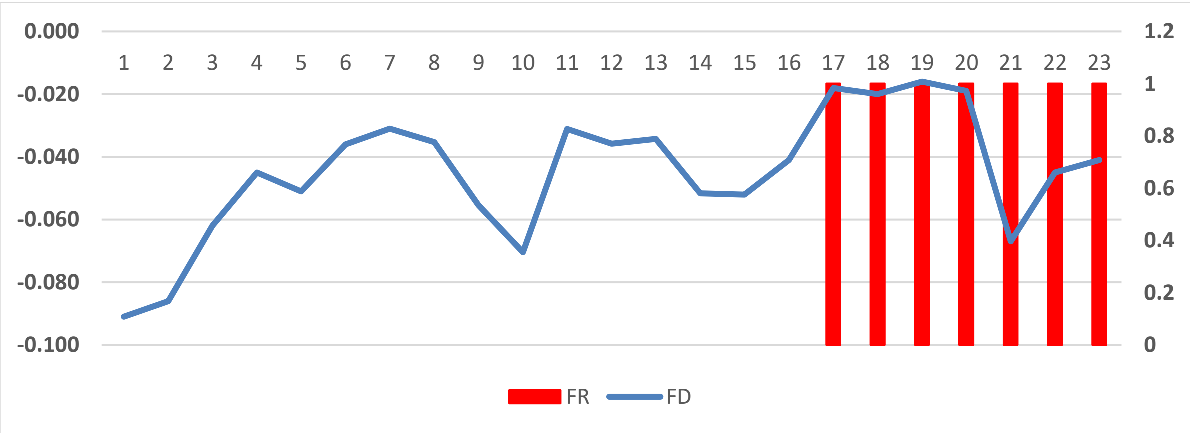

Figure 1. The Trend of the Fiscal Deficit and the Presence or Absence of Fiscal Rules
Source: Ministry of Finance and Economy and INSTAT (2023)

From the figure 1, the relationship between fiscal rules and the fiscal deficit is not very clear, as it is supported by the literature.

Economic growth - Economic growth has generally been stable, with small fluctuations mainly during the years 2010 - 2016 as a result of the global financial crisis and with a marked decline in 2020 due to the two strongest blows that hit the Albanian economy, the earthquakes of 2019 and the Covid-19 pandemic. In spite of this, the data revealed a less severe effect than anticipated, and during 2021 the economy's growth rate was noticeably faster as a result of the economic policies and regulatory measures implemented. As mentioned above, analysis and empirical evidence mostly support a negative relationship between economic growth and the fiscal deficit (balance), where high economic growth leads to a decrease in the fiscal deficit (balance). The trend of these two indicators for Albania shows a negative relationship between them in the figure below.

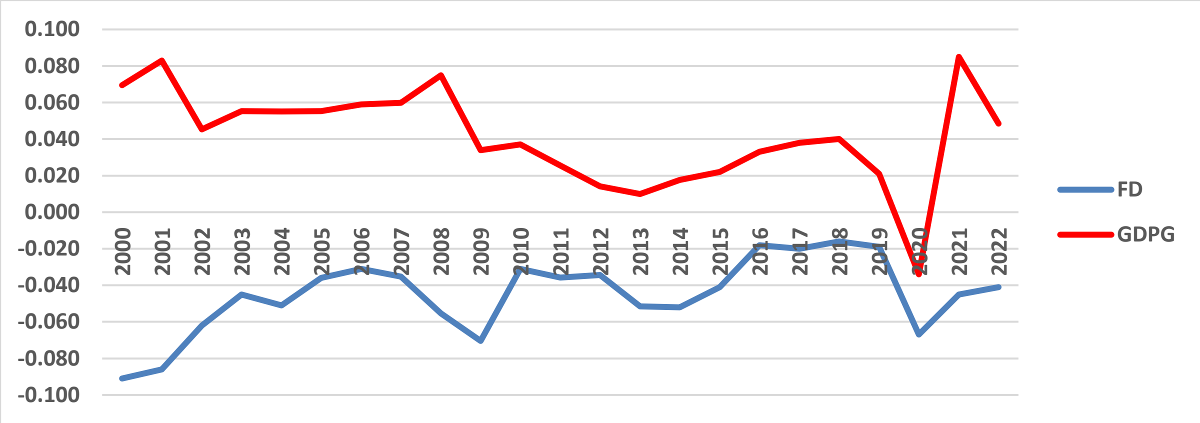

Figure 2. The Trend of the Fiscal Deficit and Economic Growth
Source: Ministry of Finance and Economy and World Bank (2023)

Public debt - another indicator that affects the fiscal deficit (balance) is the public debt. According to the OBL, "Debt" is the amount of loans received in the banking, financial market, and from third parties, natural persons, legal or individuals, subject to repayment, with or without interest, for the financing of certain investment projects, the lack of temporary liquidity and fiscal budget deficit. The chart shows that the increase in public debt above 60% of GDP started in 2012. Meanwhile, one of the criteria of international institutions is that the debt should be below 60%. Also, in the Organic Budget Law no. 57, dated 02.06.2016, it is determined that every year the public debt decreases until it reaches below the limit of 45% of GDP. Specifically, the public debt to GDP ratio has marked the highest value in 2020 (77.9%), marking 32.9 percentage points more than the limit allowed according to the OBL. This has come as a result of the increase in borrowing from the government as a result of the deepening of the deficit due to the low realization of income and the increase of expenses during 2020, the reconstruction needs from the November earthquake, as well as the situation created by the Covid-19. For empirical testing, the ratio of public debt to GDP was obtained. Referring to the analysis and empirical evidence, a positive relationship between the public debt and the fiscal deficit (balance) is supported and expected, where a higher public debt brings an increase in the fiscal deficit (balance). The positive relationship between the two indicators is given in the figure below for Albania.

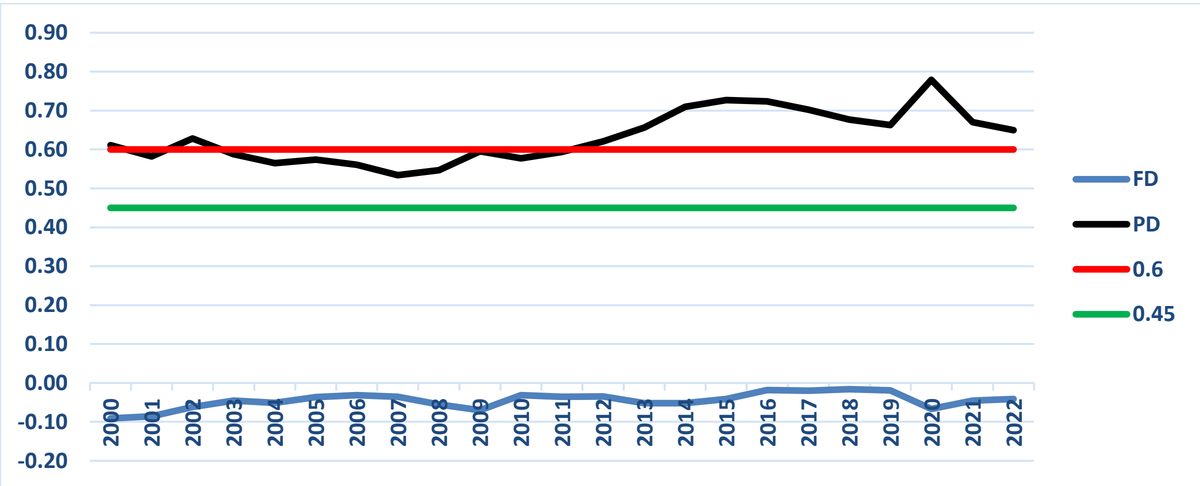

Figure 3. The trend of the fiscal deficit and ratio of public debt to GDP
Source: Ministry of Finance and Economy and INSTAT (2023)

3.2. Empirical Model, Method, And Limitations

In order to determine the econometric model, the research work is based on the model specified by the authors Marneffe et al. (2010). Since the main focus is the impact of fiscal rules on fiscal deficit, three regressions were performed: the first regression tested only the relationship between them. In the second regression, economic growth was added, while in the third case, the public debt to GDP ratio was also tested. The equations are presented as follows:

(1) $\mathbf{FD_t = \beta_0 + \beta_1 \, FR_t + \varepsilon_t}$

(2) $\mathbf{FD_t = \beta_0 + \beta_1 \, FR_t + \beta_2 \, GDPG_t + \varepsilon_t}$

(3) $\mathbf{FD_t = \beta_0 + \beta_1 \, FR_t + \beta_2 \, GDPG_t + \beta_3 \, PDr_t + \varepsilon_t}$

εt – is the error term.

The definition and the measurement of the variables are presented in the following table.

Table 1. Variable Definition, Source, and Measurement

Variable definition	Source	Measurement
Fiscal Deficit (Balance) **(FD_t)**	Ministry of Finance and Economy, INSTAT	Fiscal deficit to GDP ratio (in %) Fiscal deficit = Total Government Expenditures – Total Government Revenues
Fiscal Rules **(FR_t)**	Ministry of Finance and Economy, INSTAT	Dummy variable: 0 – fiscal rules not in place 1 – fiscal rules in place
Economic growth **($GDPG_t$)**	Ministry of Finance and Economy, World Bank	The annual percentage growth rate of GDP at market prices is based on constant local currency.
Public debt **(PDr_t)**	Ministry of Finance and Economy, INSTAT	Public debt to GDP ratio (in %)

Source: Author (2023)

To perform the regression testing, the least squares method was employed using the EViews 7 program. All statistical tests were performed to ensure the most accurate and reliable data. Since the data suffered from the unit root, during the tests, one lag time for the fiscal deficit and fiscal rules and two lag times for the ratio of public debt to GDP were added in the regressions accordingly. Also, heteroscedasticity, autocorrelation, and specification form tests were performed, bringing them to the correct form.

This model has some limitations, such as: (a) The independent variable 'fiscal rules' is a dummy variable, which takes the value of 1 for the years with fiscal rules in force. However, this variable does not show anything about the effectiveness of fiscal rules, their strength, design, or the fact of how well-known and understandable the rules are. This limitation can be addressed in further works by measuring the fiscal rules strength index for Albania, using and adapting the methodology used for EU countries, and then making the empirical evaluation using this index as a dependent variable. (b) The limited number of observations for the fiscal rules in force in Albania (6 observations in total). (c) For the year 2022, the forecast of economic growth and public debt was obtained, since the data were not available during the research work.

4. Analysis of the Empirical Results

In this section, the empirical results for the three performed regressions will be analyzed, as well as the acceptance/rejection of the hypotheses.

Table 2. Empirical Results

Variables	1st regression		2nd regression		3d regression	
	β	p-value	β	p-value	β	p-value
Constant	0.025	0.01	0.027	0.01	0.07	0.3
1st Lag Fiscal Deficit	0.439	0.02	0.553	0.01	0.53	0.02
Fiscal Rule	-0.025	0.12	-0.022	0.11	-0.011	0.55
1st Lag Fiscal Rule	0.021	0.21	0.022	0.18	0.022	0.15
Economic growth			-0.175	0.21	-0.115	0.54
Public debt ratio to GDP					0.079	0.34
1st Lag Public debt ratio to GDP					-0.18	0.15
2nd Lag Public debt ratio to GDP					0.01	0.85
Adjusted R2	0.4		0.45		0.51	
S.E. regression	0.015		0.014		0.012	
Durbin Watson	2.14		1.99		1.67	
No. Observation	22		22		21	
F-statistic	4.11		3.6		1.96	
Prob(F-statistic)	0.02		0.026		0.13	

Source: Author Computation (2023)

As shown in the table, the statistical significance (p-value) decreases when adding the variables of economic growth and the public debt to GDP ratio, whereas, in the case of the third regression, the model is insignificant at the 10% level. Meanwhile, the model in the first and in the second regression are both significant at the 5% level and none of them suffer from autocorrelation (Durbin Watson value). The explanatory power of the dependent variable increases from the first regression to the third regression, where for the first regression, the independent variable explains 40% of the dependent variable, while for the third regression explanatory variable is 51%.

Hypothesis 1. Fiscal rules have a negative impact on the fiscal deficit

Referring to the data in the table, a negative relationship between fiscal rules and the fiscal deficit in all three regressions is proved, as supported by the majority of empirical studies. The existence of fiscal rules reduces the fiscal deficit for the three regressions by 0.025 pp, 0.022 pp, and 0.011 pp, respectively. However, this relationship is statistically insignificant in each of the cases. This may be related to the fact that the fiscal rules in Albania were approved in 2016 and could not have given the proper effect. Another factor could be the crises that Albania has faced, such as earthquakes, the Covid-19 pandemic, and the energy crisis, which have influenced the increase in government spending to mitigate their negative effects. The other reason can be related to the fact that fiscal rule is a dummy variable that indicates the presence or not of fiscal rules. Meanwhile, Bandaogo (2020) emphasized that what is more important for fiscal discipline is the strength and reliability of the fiscal rule, not simply the existence of one. Saulnier and Puc (2022) confirmed the negative relationship between well-designed fiscal rules and the deficit where they can generate a reduction of it by 1.8%. Furthermore, Biase and Dougherty (2022) noted that the effectiveness of fiscal rules depends on their design and institutional elements. They emphasize that the design of fiscal rules is not enough to have the desired effect, but must be supported by a solid institution for their monitoring and implementation, as well as by political will.

Hypothesis 2. Economic growth has a negative impact on the fiscal deficit

The data in the table shows the negative relationship between economic growth and fiscal deficit in both regressions. An increase of 1 pp in economic growth leads to a decrease of 0.175 pp in the fiscal deficit in the first regression and by 0.115 pp in the second regression. However, the impact is not statistically significant, which can be attributed to the recent crises that Albania has been facing.

Hypothesis 3. The public debt to GDP ratio has a positive impact on the fiscal deficit

As shown in the table, there is a positive relationship between the public debt to GDP ratio and the fiscal deficit, as also supported by the literature, although this influence is statistically insignificant in the case of Albania. An increase of 1 pp in the public debt to GDP ratio leads to an increase of 0.079 pp in the fiscal deficit. Meanwhile, when adding the public debt to GDP ratio variable makes the model insignificant at the 10% level (p-value = 0.13).

5. Conclusions and Implications

The purpose of this paper was to empirically investigate the impact of fiscal rules on the fiscal deficit, as well as economic growth and public debt for the Albanian case. Data covering the period 2000-2022 were estimated using the least squares method with the EViews program. The analysis revealed a negative relationship between fiscal rules and economic growth with the fiscal deficit and a positive relationship of public debt with the fiscal deficit. However, the impact of each variable was statistically insignificant, which can be attributed to the short period of time of the establishment and implementation of fiscal rules in Albania (2016-2022), as well as the crises that the country has faced, which have forced governments to increase spending to mitigate their negative effects.

Since there is evidence that fiscal rules are not useful during times of crisis (Mathieu and Sterdyniak (2013), the government and researchers can analyze whether fiscal rules should be applied in times of crisis in Albania. Also, they can analyze if temporary fiscal rules in times of crisis are needed, as well as which fiscal rule can give the greatest effects to bring the economy out of the crisis, based on the country's economic context. The measurement of the fiscal rules' strength index based on the methodology used for the EU member countries can be of great importance, firstly if these implemented rules in Albania are effective, then this work can be deepened by analyzing the empirical impact of this index on the fiscal deficit.

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