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How fiscal policy affects financial development: Empirical analysis from Southeast European countries

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ABSTRACT

This study investigates the impact of fiscal policy on financial development in Southeastern European (SEE) countries from 2005 to 2023, using panel data from the World Bank Database and the Global Economy Database for 10 nations. Employing robust econometric techniques, including fixed effects, random effects, and generalized method of moments, the analysis reveals that income from taxes, public debt, and government effectiveness significantly drive financial development, with positive coefficients of 0.2680, 0.0167, and 4.4940. While government spending and fiscal freedom were included in the model, they did not show statistical significance. These findings highlight the critical role of effective tax systems, prudent debt management, and strong governance in fostering financial stability in SEE countries. The study underscores the need for targeted fiscal reforms to enhance financial development, offering valuable insights for policymakers in emerging economies.

Keywords: fiscal policy, financial development, Southeastern Europe

INTRODUCTION

Fiscal policy, as the primary tool of macroeconomic management, plays an important role in influencing financial development (Chugunov & Pasichnyi, 2024). Through the collection of government revenues and the allocation of expenditures, fiscal policy shapes economic stability, resource allocation, and long-term growth. Effective fiscal management fosters trust in financial institutions, encourages savings, and facilitates investment, all of which are essential drivers of financial development (Gara et al., 2024). This paper explores the interaction between fiscal policy and financial development in the context of the countries of Southeastern Europe (SEE), a region with unique economic challenges and opportunities.

The countries of SEE, which include Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Kosovo, Montenegro, North Macedonia, Romania, Slovenia, and Serbia, exhibit diverse fiscal landscapes shaped by historical, political, and economic factors (Trencsényi et al., 2016). These countries, in transition from socialist economies, have undergone significant reforms in their fiscal policies over the past three decades. While some have adopted strict fiscal consolidation measures to rein in public debt (PD), others have used expansionary fiscal policies to stimulate growth. The differences in these approaches provide a unique opportunity to assess how fiscal policy contributes to financial development across the region (Garcia-Ayllon, 2018).

The SEE Region, comprising countries such as Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Kosovo, Montenegro, North Macedonia, Romania, Slovenia, and Serbia, offers a unique context for studying the interplay between fiscal policy and financial development. These countries, having transitioned from socialist economies, have navigated distinct paths of economic reform, shaped by their pursuit of European Union (EU) integration and varying levels of institutional development (Trenesényi et al., 2016). The heterogeneity in their fiscal strategies–ranging from stringent consolidation to stimulate stability to expansionary policies aimed at fostering growth–combined with differences in governance quality and institutional capacity, makes the SEE region a compelling case study for examining how fiscal policy influences financial systems in emerging economies (Garcia-Ayllon, 2018).

Despite extensive studies on the role of fiscal policy in economic growth and stability, its specific impact on financial development remains unexplored, especially in the context of SEE countries. Existing research focuses mainly on developed economies, leaving a gap in understanding the mechanisms through which fiscal policy affects financial markets, institutions, and systems in emerging and transition economies. Limited attention has been paid to how regional characteristics, such as EU integration efforts and structural economic reforms, shape this relationship in the SEE context.

The objective of this research is therefore twofold. First, it seeks to empirically evaluate the extent to which fiscal policy influences financial development in SEE countries by analyzing the role of key instruments such as taxation, government expenditure, and fiscal consolidation. Second, it aims to identify which specific fiscal strategies are most conducive to strengthening financial markets and institutions in the region, considering the heterogeneity of economic structures, governance quality, and integration processes with the EU. By doing so, the study not only contributes to filling the existing research gap but also offers practical policy implications for governments and financial regulators in SEE countries seeking to foster sustainable financial development through effective fiscal management.

To address these gaps, this study aims to answer the following research questions:

1. How does fiscal policy affect financial development in SEE countries?
2. What are the main fiscal policy instruments that promote financial development in this region?

Based on the existing literature, this paper hypothesizes that fiscal policy, particularly through public spending and taxes, has a positive and significant impact on financial development in SEE countries.

While existing literature has broadly examined the relationship between fiscal policy and economic growth, very few studies have explicitly analyzed the channels through which fiscal policy influences financial development, particularly in emerging and transition economies such as those in SEE. Much of the scholarly work has focused on advanced economies, where institutional structures, financial markets, and governance frameworks are well-established, leaving a gap in understanding how fiscal measures interact with evolving financial systems in less mature economies. Moreover, the specific regional dynamics of SEE countries–characterized by their post-socialist transitions, varying degrees of EU integration, and structural vulnerabilities–remain underexplored in the fiscal-financial nexus. Addressing this gap is essential, as the unique fiscal strategies and institutional trajectories of SEE countries could provide valuable insights into the broader discourse on how fiscal policy can stimulate financial development in comparable emerging markets.

The structure of this paper is as follows: The introduction describes the purpose of the study, the research gap, and the objectives. The literature review synthesizes existing studies on fiscal policy and financial development, identifying theoretical and empirical findings. The methodology describes the econometric models, data sources, and analytical techniques used in the study. The results section presents the empirical findings, followed by the conclusions, which summarize the main insights, implications, and limitations of the study. Finally, the references provide a list of sources cited throughout the paper.

LITERATURE REVIEW

The paper by Gara et al. (2024) empirically analyzes the impact of fiscal policy on economic growth in SEE countries. The paper is conducted with panel data covering a 19-year study period (2010-2021) with a total of 11 countries. The authors apply various empirical methods using OLS, OLS robust, fixed effects (FE), random effects (RE) and generalized method of moments (GMM) models. Findings from empirical statistical analyses show that fiscal policy instruments have a positive impact on economic growth in SEE countries, while government effectiveness, rule of law and corruption show a statistically significant impact on economic growth in these countries. Meanwhile, according to the authors Bilalli et al. (2023) who use six Western Balkan countries as a case study in the 11-year period (2010-2020) through regression estimation with the FE technique, they emphasize that trade (T), inflation (ICP), interest rates (IR), and domestic credit to the private sector (DCPS) positively affect economic growth. In another research conducted in the period 2000-2020, authors Qehaja et al. (2022) analyzes the impact of government spending (GS) on economic growth and income from taxes (IFT) on GS in the Western Balkan countries. Using econometric models such as OLS, FE, and RE, the results show a positive and statistically significant relationship between fiscal policy, economic growth and financial stability, highlighting the importance of GS and IFT in promoting sustainable economic development.

According to the authors Ibrahim and Alagidede (2018) who conducted a research on the impact of the financial sector on the economic growth of African countries, which includes 29 countries and the time period of the study is long-term with a total of 35 years (1980-2014). The authors use the GMM as a regression analysis to assess the impact of the financial sector on the economic growth of this region. The authors' findings show that the financial development of African countries has a positive impact or supports economic growth. Also, the findings of statistical analyses show that the elasticity of growth to changes in the size of the real or financial sector is higher under balanced sectoral growth. Another study by Batuo et al. (2018) also conducted for African countries, but with a larger sample of 41 countries in total, over a period of 26 years (1985-2010), shows that economic growth reduces financial instability and the rate of reduction is higher in the pre-liberalization period compared to the post-liberalization period.

A study conducted for 8 arctic countries over a 29-year period (1990-2017) by Usman et al. (2022) finds that financial development along with renewable energy consumption are positively associated with economic growth in these countries over the period studied. Another study conducted with panel data of 96 countries over a 30-year period (1990-2019) by Ma and Lv (2023) who apply the regression method with GMM estimation find that financial development is associated with lower fiscal policy volatility, but an increase in financial volatility would lead to greater volatility in fiscal policy. The authors also emphasized that the detrimental effect of financial instability on fiscal policy behavior would be mitigated in the normal phase of the financial cycle, but would be magnified during expansionary, recessionary, and crisis periods.

Farooq and Yasmin (2017) examine the impact of fiscal policy uncertainty on economic growth in Pakistan from 1970 to 2011, highlighting the role of financial sector development in mitigating the negative effects. Using the auto-regressive distributed lag method, the authors find that fiscal instability, driven by GS, revenue generation, and budget uncertainty, hinders economic growth. Financial development, particularly through indicators such as liquid liabilities and private sector credit, supports economic stability. The authors emphasize that increased financial development is critical to offset the negative consequences of fiscal uncertainty and promote sustainable growth.

The study by Dinh et al. (2024) analyses the relationship between financial stability and sustainable development in 33 developing and 7 developed countries from 2005 to 2020, focusing on fiscal and monetary policy. The regression results show that financial stability positively affects sustainable development under certain conditions, such as low ICP and adequate foreign exchange reserves, but high ICP and an increase in the money supply negatively affect development in both groups. Fiscal policy, especially GS, enhances sustainable development, while the impact of IFT differs between developed and developing countries.

Makohon's (2021) paper examines fiscal policy as a crucial tool for managing socio-economic processes, particularly in Ukraine, amid modern economic challenges and globalization. It analyzes IFT within the consolidated budget of Ukraine and identifies the impact of fiscal policy on economic development. Through methods such as statistical analysis, the study emphasizes the need for financial stability, infrastructure modernization, export support, and investment stimulation. These measures aim to strengthen the effectiveness of fiscal policy in advancing national socio-economic goals.

In their analysis of Nigeria over a 51-year period (1960-2010), Adeniyi et al. (2015) examine the relationship between financial development and economic growth, highlighting nonlinearities and the impact of financial reforms. The findings show that financial development initially had a negative effect on growth, which was reversed when threshold effects were considered, indicating a turning point in the finance-growth relationship. Also, the coefficients before and after the reform showed minimal differences, questioning the effectiveness of financial reforms.

METHODOLOGY

This paper uses a quantitative methodology to analyze the impacts of fiscal factors, including government effectiveness on financial development in SEE countries over the period 2005-2023. The analysis is based on panel data collected by the World Bank Database and the Global Economy Database, covering a time period of 19 years. The study variables include the financial development index (FDI) (dependent variable) and factors such as GS, IFT, PD, government effectiveness, fiscal balance, and fiscal freedom index (FFI) (independent variables).

Research Methodology

The econometric models used for the analysis are FE, RE, and GMM. The FE and RE models are suitable for identifying differences between and across countries, considering the heterogeneity of the SEE countries. The GMM model is used to address potential endogeneity issues among variables, providing more accurate estimates when the independent variables are correlated with error terms. The use of these econometric models allows for a comprehensive analysis of the effects of fiscal factors and government policies on financial development (Ullah et al., 2018). Theoretically, FE model assumes that individual country characteristics (invariant over time) affect the dependent variable and should be included as country-specific constants (Kripfganz & Schwarz, 2019). The RE model, on the other hand, assumes that these characteristics are random and independent of the independent variables (Bell et al., 2019). To choose between FE and RE, the Hausman test will be used, which helps determine the most appropriate model (Sheytanova, 2015). GMM is an approach that combines the advantages of dynamic analysis and panel data, using lagged variables as instruments to address endogeneity and ensure robust estimates (Hall, 2015).

The selection of the most appropriate model will be based on statistical tests such as the Hausman test for FE and RE, as well as the Hansen and Arellano-Bond tests for the robustness and validation of instruments in the GMM model. Tests for heteroscedasticity and autocorrelation will also be used to ensure accurate and reliable estimates (Born & Breitung, 2016; Cheng & Bang, 2021; Clark & Linzer, 2015).

Model Specification

Eq. (1) is used for this analysis as follows:

$$Yit = \beta 0 + \beta 1(X1it) + \beta 2(X2it) + \beta 3(X3it) + \beta 4(X4it) + \beta 5(X5it) + \beta 6(X6it) + \epsilon it. \tag{1}$$

Eq. (1) represents the relationship between financial development and key fiscal and government factors in the countries of SEE. It provides a basis for analyzing the impact of these variables on the FDI, considering the different dynamics of these factors over time and space.

Y represents the FDI for country i in year t, while the variables include: *X1* GS, *X2* IFT, *X3* PD, *X4* government effectiveness index (GEI), *X5* fiscal balance, and *X6* FFI. ϵ is the error term, which represents unpredictable factors or measurement errors. These variables constitute a comprehensive model to analyze the impact of fiscal and government factors on the FDI for the countries of SEE during the studied period.

Table 1 provides a description of the variables used, including the main indicators related to financial development and fiscal policies. The FDI is measured through an index provided by the Global Economy Database while other variables such as GS, IFT, and PD are expressed as a percentage of GDP, with data provided by the World Bank Database. In addition, GEI, fiscal balance index (FBI), and FFI are measured through indices from the Global Economy Database.

Table 1. Description of research variables

Variable	Abbreviation	Unit	Data Source
Financial development index	FDI	Index (0-100)	The Global Economy Database
Government spending	GS	% of GDP	World Bank Database
Income from taxes	IFT	% of GDP	World Bank Database
Public debt	PD	% of GDP	World Bank Database
Government effectiveness	GEI	Index (-2.5-2.5)	The Global Economy Database
Fiscal balance index	FBI	Index (-10-10)	The Global Economy Database
Fiscal freedom index	FFI	Index (0-100)	The Global Economy Database

Table 2. Descriptive statistics of variables

Variable	Obs	Mean	Standard deviation	Minimum	Maximum
FDI	190	83.56	8.20	63.00	97.00
GS	190	19.21	4.82	10.38	34.30
IFT	190	40.16	9.09	17.02	55.93
PD	190	66.00	38.84	3.45	150.48
GEI	180	.11	.50	-1.04	1.18
FBI	180	-2.73	3.84	-21.42	6.65
FFI	180	77.98	15.18	12.00	96.00

Table 3. Descriptive statistics for SEE countries

Country	FFI	GS	IFT	PD	GEI	FBI	FFI
Albania	89.95	11.18	53.66	38.92	-0.18	-3.93	87.50
Bosnia and Herzegovina	83.95	21.53	43.44	43.84	-0.69	0.28	82.00
Bulgaria	88.05	17.47	44.16	118.07	-0.02	0.03	88.89
Croatia	83.37	21.23	45.72	123.69	0.55	-3.63	70.39
Kosovo	67.47	29.46	18.72	12.10	0.65	-0.81	48.94
Montenegro	87.37	20.80	43.08	69.27	0.10	-5.58	83.33
North Macedonia	87.68	16.91	41.16	81.19	-0.10	-2.75	88.56
Romania	81.05	16.11	35.69	31.78	-0.14	-4.18	84.33
Serbia	84.26	17.99	41.72	44.95	-0.08	-3.05	84.50
Slovenia	82.53	19.47	34.28	96.29	1.06	-3.78	61.44
Average of SEE countries (2005-2013)	**83.57**	**19.22**	**40.16**	**66.01**	**0.11**	**-2.74**	**77.99**

Note. Data presented as average for the period 2005-2023

RESULTS

The descriptive statistics presented in **Table 2** provide a comprehensive overview of the key variables analyzed in this study, focusing on fiscal factors and government effectiveness in relation to financial development across SEE countries from 2005 to 2023. The FDI shows a mean value of 83.56 with a relatively low standard deviation of 8.20.

GS, expressed as a percentage of GDP, has a mean value of 19.21, with a standard deviation of 4.82. This variability points to different fiscal priorities and spending capacities among the countries included in the analysis. IFT demonstrate an average of 40.16% of GDP with a wider distribution (standard deviation of 9.09), highlighting differences in tax capacity and collection efficiency across countries, influenced by economic structure and governance factors.

PD, with an average of 66.00% of GDP and a sizeable standard deviation of 38.84, highlights significant heterogeneity in debt burden within the region.

GEI, an index ranging from -2.5 to 2.5, has an average of 0.11 and a standard deviation of 0.50. While the average suggests a moderate level of effectiveness in the region, the minimum negative value (-1.04) indicates instances of governance challenges, which may hinder the implementation of fiscal and development policies. On the other hand, the FBI, with an average of -2.73 and a relatively high standard deviation of 3.84, shows a tendency of fiscal deficits among the sample countries, reflected in the negative average value. Finally, the FFI, with an average of 77.98 with a standard deviation of 15.18, suggests a relatively high level of fiscal autonomy and policy flexibility.

Descriptive statistics in **Table 3** highlight significant variations among SEE countries in terms of fiscal factors, financial freedom, and government effectiveness over the period 2005-2023. The FFI, a key indicator of financial development, exhibits considerable variation, ranging from 48.94 in Kosovo to 88.89 in Bulgaria. Kosovo, with the lowest FFI, reflects limited financial development, potentially due to structural challenges and a relatively young financial market. Bulgaria and North Macedonia demonstrate higher levels of financial freedom, indicating more advanced financial systems and better regulatory frameworks. GS, expressed as a percentage of GDP, also exhibits notable variation. Kosovo leads with an average GS of 29.46% of GDP, significantly exceeding the regional average of 19.22%. This high level of spending may reflect investments in infrastructure and public services during the post-independence period. On the other hand, Albania, with the lowest GDP at 11.18%, shows a weaker public spending profile, which may be related to a more limited fiscal capacity or to deliberate austerity measures.

Table 4. Results of correlation analysis

Variables		FDI	GS	IFT	PD	GEI	FBI	FFI
FDI	Correlation	1	-.545**	.662**	-.309**	.299**	.095	.656**
	Significance		.000	.000	.000	.000	.203	.000
	N	190	190	190	190	180	180	180
GS	Correlation	-.545**	1	-.704**	-.154*	.357**	.129	-.632**
	Significance	.000		.000	.034	.000	.083	.000
	N	190	190	190	190	180	180	180
IFT	Correlation	.662**	-.704**	1	.359**	-.453**	-.114	.639**
	Significance	.000	.000		.000	.000	.127	.000
	N	190	190	190	190	180	180	180
PD	Correlation	-.309**	-.154*	.359**	1	.280**	-.153*	.101
	Significance	.000	.034	.000		.000	.040	.179
	N	190	190	190	190	180	180	180
GEI	Correlation	.299**	.357**	-.453**	.280**	1	-.122	-.610**
	Significance	.000	.000	.000	.000		.102	.000
	N	180	180	180	180	180	180	180
FBI	Correlation	.095	.129	-.114	-.153*	-.122	1	-.075
	Significance	.203	.083	.127	.040	.102		.318
	N	180	180	180	180	180	180	180
FFI	Correlation	.656**	-.632**	.639**	.101	-.610**	-.075	1
	Significance	.000	.000	.000	.179	.000	.318	
	N	180	180	180	180	180	180	180

Note. *Correlation is significant at the 0.05 level (5%) & **Correlation is significant at the 0.01 level (1%)

PD, another critical fiscal factor, varies widely across countries. Croatia and Bulgaria report the highest levels of PD, at 123.69% and 118.07% of GDP, respectively, well above the regional average of 66.01%. These figures may signal fiscal weaknesses, particularly in managing long-term debt sustainability. On the other hand, Kosovo reports the lowest PD, at 12.10%, suggesting limited borrowing capacity due to its relatively young economy.

The GEI and the FBI further highlight institutional and fiscal imbalances. Slovenia demonstrates the highest government effectiveness score (1.06), reflecting efficient public services and strong institutional quality. Kosovo and Bosnia and Herzegovina, with scores of 0.65 and -0.69, respectively, highlight challenges in governance and institutional capacity. Meanwhile, the FBI ranges from -5.58 in Montenegro to 0.28 in Bosnia and Herzegovina, suggesting varying capacities to manage fiscal deficits. Montenegro's sizeable fiscal imbalance may indicate a reliance on debt-financed spending, potentially impacting financial development and macroeconomic stability.

The results of the correlation analysis presented in **Table 4** show that there is a statistically significant negative correlation between GS and FDI (-0.545, $p < 0.01$). This suggests that higher levels of GS are associated with lower levels of financial development in SEE countries. Excessive spending expenditure may discourage private investment, reduce financial market efficiency, or divert resources from financial sector growth. Conversely, IFT shows a strong positive correlation with FDI (0.662, $p < 0.01$), indicating that higher IFT is associated with better financial development. This relationship may reflect the positive role of fiscal capacity in financing public goods and services that support financial markets, such as regulatory frameworks and infrastructure. Similarly, the FFI exhibits a significant positive correlation with FDI (0.656, $p < 0.01$), highlighting the importance of fiscal policies that promote financial autonomy and lower tax burdens in fostering financial development.

PD shows a weak but statistically significant negative correlation with FDI (-0.309, $p < 0.01$). This implies that higher levels of PD may hinder financial development, potentially due to concerns over fiscal sustainability and the dampening effect of government borrowing on private credit markets. Interestingly, GEI is positively associated with FDI (0.299, $p < 0.01$), suggesting that institutional quality and efficient public administration play a supporting role in enhancing financial development.

The FBI, however, does not show a statistically significant relationship with FDI (0.095, $p = 0.203$), indicating that fiscal surpluses or deficits alone may not have a direct impact on financial development in the region.

Figure 1 presents an analysis of the FDI in SEE countries, highlighting changes in financial development over the observed period. The chart shows that Albania and Bulgaria exhibit higher levels of financial development compared to other countries, with their average FDI values positioned closer to the upper limit. Slovenia also shows a wider range, indicating variability in financial development over time. Kosovo reports the lowest average FDI, with a narrow range, suggesting consistently lower levels of financial development compared to its regional counterparts.

Montenegro and North Macedonia suggest relatively stable trends in financial development over time. Meanwhile, the spread observed in Bulgaria and Croatia indicates fluctuating financial development, potentially influenced by different fiscal or institutional conditions.

The diagnostic test results (**Table 5**) suggest that the appropriate model for data analysis is the GMM. The VIF value (2.16) indicates a lack of multicollinearity among the independent variables, guaranteeing the stability of the regression results. The heteroskedasticity test (Hettest) with a

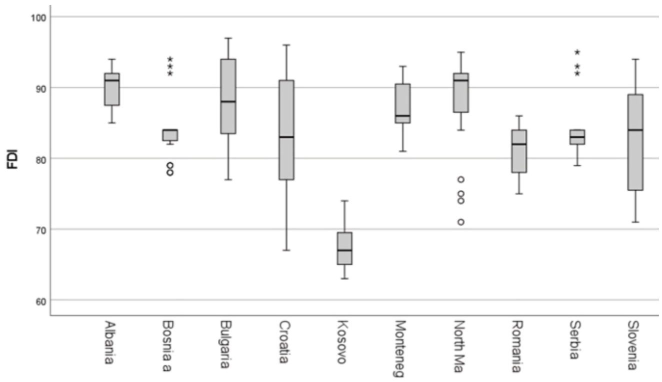

Figure 1. Box-plot results for differences in financial development in SEE countries (Source: Authors' own elaboration)

Table 5. Results of econometric models

Variables	FE	RE	GMM
GS	0.203	-0.00853	1.229
	(0.86)	(-0.05)	(1.85)
IFT	0.163	0.340**	0.268**
	(0.98)	(3.14)	(3.21)
PD	0.0156**	0.0156***	0.0167***
	(2.49)	(3.78)	(3.46)
GEI	3.078***	2.312***	4.494***
	(3.33)	(4.45)	(4.96)
FBI	0.111	0.0814**	0.307**
	(0.84)	(2.7)	(2.29)
FFI	0.218***	0.238***	0.134
	(4.48)	(5.32)	(1.59)
L.FDI			0.906***
			(10.8)
_cons	54.70***	50.09***	-13.09
	(5.82)	(6.9)	(-0.65)
N	180	180	170
VIF			2.16
Hettest			p = 0.286
Arellano-Bond test for AR(1) in first differences			p = 0.003
Arellano-Bond test for AR(2) in first differences			p = 0.045
Sargan test			p = 0.734

Note. t-statistics in parentheses; *$p < 0.05$ **$p < 0.01$; & ***$p < 0.001$

p-value of 0.286 indicates that there is no heteroskedasticity present, which supports the adequacy of the models used.

The Arellano-Bond test for AR (1) and AR (2) suggests that there is significant correlation in the first ($p = 0.003$) and second ($p = 0.045$) order of the first changes, supporting the dynamic model approach such as GMM to address the problems of autocorrelation and instrumental variables. The Sargan test ($P = 0.734$) shows that the moment constraints are valid, verifying that the chosen instruments are appropriate. These indicators make the GMM model more suitable compared to FE and RE models, which are not able to effectively handle the dynamic problems of autocorrelation and endogeneity.

The variable GS has a coefficient of 1.22 but is not statistically significant ($p > 0.05$). Thus, GS does not have a strong impact on the FDI in the region. IFT, with a coefficient of 0.268, is statistically significant, indicating that IFT are a determinant of financial development in this model.

PD and GEI show significant and positive impact on financial development. PD has a coefficient of 0.0167 and is highly significant ($p < 0.001$), suggesting that higher levels of PD are positively associated with financial development. Similarly, GEI has a coefficient of 4.494 and is also statistically highly significant ($p < 0.001$), indicating that government effectiveness plays a key role in improving financial development.

FBI is a significant factor, with a positive coefficient of 0.307 ($p < 0.01$), indicating that fiscal balancing helps improve financial stability. While FFI, although it has a positive coefficient of 0.134, is not statistically significant. The value of the lagged FDI (L.FDI) variable is 0.906 and is highly significant ($p < 0.001$), indicating that financial development in past periods has a large and consistent impact on the current period.

The findings of this study highlight the determinants of financial development in the analyzed region, contributing to the broader literature on fiscal policy and financial stability. GS, despite its theoretical importance, does not significantly affect the FDI, aligning with the findings of Gara et al. (2024) that the effectiveness of fiscal policy depends on various contextual factors. However, IFT demonstrate a statistically significant positive effect, confirming the conclusions of Qehaja et al. (2022), who emphasize the critical role of fiscal revenues in promoting financial and economic stability in the Western Balkans. This result supports the view that effective revenue collection mechanisms support the development of the financial system.

PD and GEI emerge as the main drivers of financial development, in line with the studies of Ibrahim and Alagidede (2018) and Dinh et al. (2024), which highlight the importance of governance and fiscal prudence in fostering financial stability. The high importance of these variables highlights the necessity for sound debt management and institutional quality to enable financial development. The positive impact of FBI is consistent with the findings of Farooq and Yasmin (2017), who highlight the stabilizing effect of fiscal discipline on financial systems. Furthermore, the important role of L.FDI in shaping current financial development reflects the path dependence highlighted by Ma and Lv (2023), who note that financial stability in previous periods can mitigate fiscal instability in the future. The FFI is not statistically significant, which contradicts the conclusions of studies such as Batuo et al. (2018), suggesting that the effect of fiscal liberalization varies by region and stage of development. These results further corroborate the literature that highlights the contextual sensitivity of fiscal policies, as reflected in divergent results across regions and study periods. The study findings suggest that while certain fiscal policies, such as IFT mobilization, have universal impact, others, such as GS, require context-specific assessment. These insights add to the growing body of evidence on the complex interaction between fiscal policy and financial development.

Based on the results provided, the hypothesis that fiscal policy, especially through public spending and taxes, has a positive and significant impact on financial development in the SEE countries can be partially supported. The coefficient for IFT is positive (0.268) and statistically significant ($p < 0.05$), indicating that IFT contributes to financial development in the region. However, GS, with a coefficient of 1.22, is not statistically significant ($p > 0.05$), suggesting that public spending does not have a strong or direct impact on financial development in this context. Other fiscal policy variables, such as PD and GEI, exhibit significant positive effects, with coefficients of 0.0167 ($p < 0.001$) and 4.494 ($p < 0.001$), respectively. These results indicate that broader fiscal governance and PD management are crucial drivers of financial development. While the hypothesis is supported for the impact of IFT, the lack of statistical significance for GS suggests that the relationship between fiscal policy and financial development is nuanced and depends on specific fiscal components and governance factors.

DISCUSSION

The empirical results of this study show that IFT, PD, GEI, and FBI are significant determinants of financial development in SEE countries, while GS and the FFI do not exhibit a strong statistical impact. These findings partially support the initial hypothesis that fiscal policy positively influences financial development but also reveal that not all fiscal instruments exert the same effect. This aligns with the work of Qehaja et al. (2022), who highlighted the critical role of tax revenues in promoting economic stability, and with Dinh et al. (2024), who emphasized that fiscal variables such as GS and tax income affect long-term financial sustainability. However, unlike Qehaja et al. (2022), this study does not find GS to be a significant contributor to financial development, suggesting that the effectiveness of fiscal expenditures depends heavily on governance quality and institutional efficiency.

The positive and significant effect of PD supports earlier findings by Ibrahim and Alagidede (2018) and Ma and Lv (2023), which stressed the importance of fiscal and financial structures in maintaining economic stability. The results suggest that, in the SEE region, PD can contribute to financial development when accompanied by sound management practices and effective governance. Similarly, the strong significance of GEI resonates with the findings of Gara et al. (2024), who demonstrated that institutional quality, rule of law, and governance play a pivotal role in shaping the outcomes of fiscal policy. This underscores that institutional frameworks and governance structures remain central to determining how fiscal measures translate into financial development outcomes.

The study also highlights the importance of FBI as a stabilizing factor for financial systems, in line with the conclusions of Farooq and Yasmin (2017), who argued that fiscal discipline reduces uncertainty and supports financial stability. Moreover, the significance of L.FDI indicates a path dependency in financial systems, echoing Ma and Lv’s (2023) finding that past financial stability can mitigate fiscal instability and enhance resilience against shocks. The insignificance of the FFI in this study diverges from Batuo et al. (2018), who found that liberalization can reduce financial instability. This discrepancy may be explained by the different structural contexts African countries in their study versus SEE transition economies here highlighting that fiscal liberalization may not uniformly benefit financial development across regions.

These results contribute to the literature by showing that fiscal policy’s effect on financial development in SEE is selective and context-dependent. While tax revenues, fiscal balance, and governance quality emerge as robust drivers, the role of GS remains less direct than previously suggested in some studies. This nuance adds to the debate in the literature, suggesting that fiscal instruments do not operate in isolation but are conditioned by institutional frameworks and regional economic structures. Thus, the findings confirm parts of the existing literature while also challenging generalized assumptions about the universal impact of fiscal policy on financial development.

CONCLUSIONS

The findings of this study provide insights into the relationship between fiscal policy and financial development in SEE countries. IFT is an important determinant of financial development, confirming that effective tax collection policies can enhance financial stability and growth. Conversely, GS does not show a statistically significant impact, suggesting that the way public spending is allocated and used may dampen its effect on financial development.

A key point from the analysis is the important role of PD and GEI in shaping financial development in the region. The highly significant and positive relationship between PD and financial development suggests that when managed responsibly, PD can be a catalyst for financial sector growth, potentially enabling infrastructure investments and other development-enhancing initiatives. Similarly, government effectiveness, as indicated by its high statistical significance, underscores the importance of good governance, efficient resource allocation, and policy implementation in fostering financial development. These findings highlight the need for SEE countries to strengthen institutional capacities and governance structures to maximize the impact of fiscal policies.

The FBI also emerged as an important variable contributing to financial development, indicating that maintaining fiscal discipline and balanced budgets supports financial stability and growth. However, the FFI, although positively related, was not statistically significant, implying that broader measures of fiscal freedom may have a limited direct impact on financial development. This suggests that specific fiscal policy actions, rather than general fiscal conditions, are more critical in determining the growth trajectory of the financial sector in the region.

The L.FDI was found to be a strong predictor, indicating that financial development is self-reinforcing. This highlights the importance of building a strong financial system over time, as past improvements in financial development contribute significantly to current growth. The interaction between fiscal policy and financial development is thus dynamic, requiring sustained and strategic efforts to support progress in the financial sector.

While fiscal policy plays a key role in influencing financial development, its effectiveness depends on the quality of governance, prudent debt management, and targeted fiscal interventions. Policymakers in SEE should focus on improving tax systems, improving PD management, and strengthening institutional frameworks to foster financial development. Balancing fiscal policies with sound economic strategies can create an environment conducive to financial stability and long-term growth. These findings provide a basis for future research and policymaking aimed at optimizing fiscal policy to support financial development in the region.

This study's findings underscore the nuanced impact of fiscal policy on financial development in SEE countries, yet certain limitations warrant consideration. Limited attention has been given to how regional characteristics, such as EU integration efforts and structural economic reforms, shape the fiscal-financial nexus in the SEE context. These factors, critical to the region's economic transformation, may influence the effectiveness of fiscal policies in fostering financial development. Future research could address this gap by explicitly incorporating variables related to EU integration processes or structural reforms, such as regulatory harmonization or market liberalization metrics, to better understand their role in mediating the relationship between fiscal policy and financial development in SEE countries.

To enhance the effectiveness of fiscal policy in promoting financial development, policymakers in SEE countries should implement targeted measures, such as improving tax administration efficiency through digital tax systems to boost compliance and broadening the tax base by including untaxed sectors like informal economies. Additionally, the path-dependent nature of financial development, evidenced by the significant role of L.FDI, suggests that policymakers can build on past gains by prioritizing long-term financial sector reforms, such as strengthening regulatory frameworks and promoting financial inclusion. However, this study's reliance on aggregate data may overlook country-specific dynamics, and the exclusion of variables like monetary policy interactions limits its scope. Future research could address these gaps by using disaggregated data or exploring additional factors, such as private sector investment, to deepen insights into fiscal policy's impact on financial development.

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