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Tax Policy in the Context of Economic Growth and Development

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Abstract

The purpose of this study is to identify in the specific literature the influence of fiscal policy in the context of economic growth and development. There are also presented, in a brief summary, the main macroeconomic approaches of the concept of tax policy. However, there are other models that describe the expansionist fiscal policy influence on consumption, such as: Corsetti's theory and others (2009) explain that the increase in public expenditure will not necessarily be funded by increasing taxes and Blinder's theory (2004) shows that temporary tax decreases tend to generate the current consumption growth because consumers want to maximize the current consumption at the expense of future consumption. Besides, the influence of fiscal adjustment on growth and economic development also appears in context.

Keywords: Economic Growth, Economic Development, Fiscal Policy, Expansive Fiscal Policy, Restrictive Fiscal Policy, Fiscal Consolidation, Fiscal Adjustment

Economic Growth. Conceptual Approaches

Economic growth is a complex process that involves all economic phenomena and processes, representing the upward evolution of the economy, increasing national income, gross domestic product growth for a certain period of time. Economic growth involves improving the indicators of life quality of life through effective use of economic resources and can be expressed through the real growth either of the gross domestic product (real appreciation of the growth level) or the per capita gross domestic product.

The research-studies on the impact of fiscal policy on economic growth reveal that the pace of growth of the gross domestic product and its per capita levels are influenced by a set of exogenous factors in the regression equation. According to economic theory, *zero growth economy* is characterized by maintaining the pace of economic growth but also of the total population, which keeps per capita economic results level constant; by reducing it, a new concept *negative economic growth* has appeared.

The ways in which fiscal policy can influence economic growth occur through production function: the material and real capital investment; the quantity and quality of the human factor; the technical factor essential for economic efficiency and growth.

Subsequently, the State can influence economic growth through:

1. Policies that influence labour productivity: education expenses or health expenses;

2. Policies that influence physical capital productivity: capital expenses, cash transfers, research and development expenses etc.;

3. Policies that influence the capital quantity and labour force in economy.

The progress of the long-term macroeconomic results stands for economic development, such as production factor development, service sector development, science development etc.

Economic growth pinpoints the qualitative and structural aspects of the economic evolution - infrastructure, business environment development, job creation, and higher life standard.

The strategy of development must include specific policies and support the establishment of some institutions considering a series of factors such as the specific domestic economy specificity, regional integration, globalization, cultural values etc.

In this regard, the United Nations has proposed 2 indicators for determining the level of¹ the economic growth per country: the first one, Human Development Index- refers to life expectancy, level of education and adjusted real income and the second one, Human Poverty Index- denotes the number of illiterate people, those without any access to medical care services and running water.

Economic growth policies must combine the market mechanism with the functions of the State. Taxation can be used to control the demand and aggregate supply by changing the structure and level of taxes and fees.

Fiscal Policies - Component of Macroeconomic Policies

Taxation in the context of modern macroeconomic approaches²:

1. New classical economy (Lucas, Sargent) provides the following arguments regarding the diminished impact of fiscal stocks:

- modification of the aggregated demand has little influence on the level of production and incomes in economy;
- economic agents optimize their rational choices related to consumption;
- prices and salaries have a higher degree of flexibility;
- according to the Ricardian equivalence, the increase of public expenses funded either by loans or taxes and fees does not generate an improvement of the life standard, as consumption and GDP do not change.

2. Neoclassical visions (Hicks, Samuelson) - GDP evolution is influenced by the aspects related to supply - accumulation of capital and labour force. According to this theory, expansionary fiscal policy will generate increasing consumption and GDP growth only in the short term, but in the medium term-specific aggregate supply constraints will lead to a reduction of GDP by expansionary fiscal shock level.

3. Real business cycle theory (Kydland, Prescott) - business cycles are influenced by the fluctuations of the rate of increase in the overall productivity of the factors of production. Tax policy becomes effective only if it generates sustainable GDP growth. In regard to real economy, reducing taxes determines increase of investment, demand and supply, as well as an increase of employment rate.

The research studies regarding the impact of taxation on economic growth demonstrated a negative correlation between them. Fiscal policy is expected generate a

¹ Ciobanu R. (2010). "Economic Growth and Development. Taxation as A Supporting Factor", RFPC no. 9, p. 53.

² Marinus M.C. (2010). "Fiscal Policy Efficiency Regarding the Fight against Economic Crisis Effects. An Analysis Based on Economic Literature", Theoretical and Applied Economy, vol. XVII, no. 11, pp. 53 – 55.

framework proper to the development of an economic growth environment by supporting investments, development of private sector and modification of revenues structure and budgetary expenses.

Under such circumstances, in setting up a fiscal policy, the following aspects should be taken into account: the fiscal position – the structure of revenues and budgetary expenses. An expansionary fiscal policy influences a significant increase of budgetary expenses, while a restrictive fiscal policy results from increasing tax rates.

Usually, national fiscal policies are either in favour of labour taxation or consumption taxation.

Fiscal policy measures are set by the State with respect to the categories of taxes and fees, as well as the way they are used as a lever for stimulating economic growth and economic development. It also should be centred on providing a stimulating and non-discriminatory environment, focusing, at the same time, on certain measures meant to enhance stability and predictability.

The *Report to the European Council of 18-19 October 2012-“Implementation of the Pact for Economic Growth and Jobs,”* shows that the huge potential of a single market as engine of economic growth in the European Union is not fully exploited. The Commission has carried out a series of proposals regarding the revision of the Directive on savings income taxation, the consolidated fiscal base for all companies, energy taxation and the negotiation mandates regarding the taxation of savings income with third countries-proposals that will contribute to increasing public revenue and creating opportunities for stimulating economic growth and institutional support.

E.U member states are required to focus on strengthening differentiated taxation favourable to economic growth and development.

In Romania, the measures related to fiscal consolidation in accordance with *Fiscal Budgetary Strategy for 2013-2015* are:

- Investment expenses over the 2013-2015 period stand for 6.8-7.2% of GDP comparable with 6.5-6.8% of GDP as forecast over the 2012-2014 period;
- The wage cost ceiling reaches 6.7% of GDP for 2012, 7.1% of GDP for 2013 and 6.8% of GDP for 2015;
- Serious fight against tax evasion and increase of the efficiency related to collecting taxes and fees.

Strategy of Fiscal Adjustment within the Context of Economic Growth and Development

Globally, all states are facing challenges related to fiscal adjustment.

Fiscal adjustment is defined as the situation in which fiscal policy is achieved through budgetary deficit decrease.

The effects on the real economy, generated by fiscal adjustment are considered expansionary effects³ if the average rate of growth of real GDP in the period of adjustment and the next 2 years is at least a standard average rate is at least one standard deviation over the growth rate average registered during the reporting period. For the analysis of the fiscal adjustment process must be followed: the size of the adjustment, the type of adjustment either by increasing revenue or reducing expenditure, as well as the macroeconomic consequences of fiscal adjustment.

³ Purfield, C. (2003). *“Fiscal Adjustment in Transition Countries: Evidence from the 1990s”*, IMF Working Paper 03/36/2003, qtd. Brasoveanu Obreja L., Dragora V. et. al. *“Adjustment and Optimization of Fiscal Adjustment Strategy for Stimulating Economic Growth”*, project code ID_1786/2009, p. 8.

Fiscal adjustment may group in two categories⁴:

- **Type 1** – decrease of public expenses, mainly transfers, social insurances, wages and budgetary employees; increase of taxation is only a part of the adjustment process;
- **Type 2** – increase of taxation level related to population's revenues and contribution to social insurances; adjustment through expenses refers to the decrease of public investments.

Type 1 fiscal adjustment generates a more sustainable and expansionary fiscal consolidation.

Type 2 fiscal adjustment is irreversible in short time and has contracting consequences on economy. If *Type 1* fiscal adjustment refers to budgetary salaries and welfare programmes, *type 2* fiscal adjustments has a temporary contracting effect through the channel of the aggregated demand. At the same time, fiscal contraction (*type 2 fiscal adjustment*) may also have expansionary consequences through: the welfare effect on consumer, on job offer etc.

Recent research studies reveal that there are sufficient channels - anticipation channel and wealth channel, by the means of which fiscal adjustment may produce positive effects on consumption and economic growth.

Fiscal projections are grounded on the macroeconomic scenario resulting from the model of macroeconomic analysis and prognosis of NBR (National Bank of Romania). The projections of the relevant macroeconomic variables (GDP, deflators, consumption, occupancy, wages, interests, exchange rates etc.) interact with discretionary measures for revenues and expenses issue in order to produce a prognosis of the balanced consolidated general budget (BGC) corresponding to year t and to the following two years – $t+1$, $t+2$. BGC incomes and expenses are in accordance with ESA 95 (BCE, 2007) – standard that has as main differences, comparable with cash methodology, the record of revenues and expenses in "accrual" system (considering engagements and not effective payments as in cash system) and EU funds treatment.

Adjusting balanced consolidated general budget to the cyclic factors facilitates the policy analysis and therefore the screenings of revenues, expenses and balances.

From the economic point of view, the cyclic adjustment tries to determine the increase of balanced consolidated general budget (BGC). The identification of the structural fiscal position allows the assessment of the way in which fiscal policy fulfils its role of macroeconomic stability trigger.

Structural fiscal position stands for the deficit size that could have prevailed in the absence of economic cycle influences.

Effective balance = structural fiscal position + cyclical component

(1)

Cyclical component = excess demand x budget balance adjusted to excess demand

(2)

Thus, fiscal position reflects the modifications appeared in the structural balance from one moment to another.

⁴ Brasoveanu Obreja L., Dragora V. et. al. "Adjustment and Optimization of Fiscal Adjustment Strategy for Stimulating Economic Growth", project code ID_1786/2009, p.8.

Conclusions

In this study we conducted a brief synthesis of the main macroeconomic approaches on tax policy in the context of economic growth and development. Regarding the fiscal policy, more emphases have to be put on strengthening the tax differential and favourable to economic growth, stability and predictability. Also, in the process of fiscal adjustment, one should take into account the types of fiscal adjustments processed through the following correlations: fiscal consolidation – expansionary fiscal policies (type 1 fiscal adjustment) as well as fiscal contraction with both contracting and expansionary consequences on the economy.

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