AUTOMATIC STABILIZERS AND FISCAL REFORMS

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Abstract

In the context of recent economic and financial crises, it is increasingly the question of using a rapid and a more effective macroeconomic tool to stabilize national, regional or global economic activity. In this sense, automatic stabilizers seem to be an increasingly popular solution both agreed by economic theory and by economic practice. The fiscal policy reforms, with better conceived expenditure and tax tools, are analyzed in literature and have usually an impact in raising long-term growth, but growth is usually fragile when disregards the inclusion effect. Thus, the article treats the delicate subject of fiscal reforms, economic growth and (automatic) stabilization tools in order to shed some light on the relationship between them.

Keywords: *automatic stabilisers, fiscal reforms, smoothing the economic cycle;*

JEL classification: *H11, H30, E63*

Introduction

Tax policy can act on macroeconomic and microeconomic growth. At macroeconomic level, it is an element of economic stability alongside credible monetary policy and can boost investment, labour productivity and job creation, create or reduce business distortions, boost households to save or to consume, can bring social categories closer to each other through a more correct distribution of income and by increasing access to education and health, or can generate social inequality, etc. Therefore, fiscal and budgetary changes with substantial impact on society on the above elements may be arguments in favour of implementing reforms.

By definition, reform requires a transformation, a reconfiguration, a political, institutional, economic, social, cultural, legal reorganization, etc. of a structural nature and limited in duration over time in order to achieve progress or to limit shortcomings in the system. Reform implies, of course, besides the possible expected benefits and a process of alteration, destruction, dismantling and building again; therefore, there will be a number of important costs of reforming, and it will be necessary to analyze its usefulness or futility. For example, it needs to be analyzed whether in order to reduce distortions in the economy it is necessary to adjust from year to year or to implement a tax reforms or it is better to keep the tax rates throughout the economic cycle as stable as possible in order to allow automatic stabilizers to function.

Also, the problem of its usefulness or its inutility can be disjointed from the perspective of the implementation time and the time of the results delivering, and of course it is desirable, as in the case of automatic stabilizers, a shorter implementation time, with beneficial results as long as possible. However, automatic (fiscal) stabilizers can constitute a two-edged weapon: on the one hand, providing adequate protection to those affected by adverse economic changes through tax legislation, social security systems and labour market institutions but, on the other hand, the same protection allows people and companies affected by negative economic cycle to delay to adapt to changes, contributing to the diminutions of economic efficiency and potential output, thus delaying an appropriate response to supply shocks.

At the same time, the fiscal reform, being of course the privilege of governmental apparatus, implies the achievement of a significant (over a certain threshold) with normative change, which the fiscal policy imposes on its component elements. The tax reform therefore describes the relevant changes to the system of generating public revenues and spending a country's revenue in support of the production and distribution of public goods and services, but also in order to guide the economic behaviour of society according to government objectives.

If we want to make a clearer theoretical link between automatic stabilizers and tax reforms, we can consider the simplification of the classification of the tax reform according to the structural criterion, the normative axis presented in the paper "Economic Sustainability through Globalization Adjustment Policies" (Dinga et al., 2011, pp119, fig. 36). Simplifying further, as modern tax systems aim at balancing

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between active and passive functions (for example, trying to stimulate or inhibit economic behaviours based on increased tax collection capacity in order not to create budgetary imbalances), we can only refer to reforms that regard the tax system as being mixed. At the same time, if from the perspective of the fiscal sphere we consider the extension (the increase of taxation towards other lucrative economic activities) as a form of increasing the degree of granularity of the tax base, we can only refer to capillarisation of the tax base. Equally, given that automatic stabilizers aim in particular at a progressive tax regime, that is to say, pursuing greater social equity through taxation, by simplifying, we can only refer to this regime. Therefore, the fundamental features of the reforms regarding automatic stabilizers, from the perspective of: - form implies progressivity, - behaviour involves non-discretionarily or implicit action, - purpose, involves a mixed system (oriented rather to stimulation) and from the perspective of the sphere involves capillarization.

Therefore, this article proposes to argue and harmonize the idea of fiscal reform with the automatic stabilization concept, the way in which the two subjects are mutually reinforcing or, on the contrary, conflicting. The idea of developing and implementing fiscal reforms to support as much as possible the macroeconomic stabilization process as much as possible is not new, but also isn't extremely well sustained theoretically and practically.

Description of the Problem and short Literature Review

Equally, reforms involve clear budgetary and fiscal policy decisions, so obviously a discretionary character, or in a recession, tax revenue falls naturally, and social transfers grow. Thus, the distinction between the growing government expenditures caused by the fiscal-budgetary policy decisions and those that representing automatic changes of the tax variables in response to the economic cycle is difficult to achieve. At the same time, from a fiscal and budgetary perspective, reforms can aim at achieving the best possible stabilization function.

Tax reforms generally refer to either revenue or expenditure, or mixed. Revenue reforms can focus on the elimination of gaps and distortions and the expansion of the tax base and / or rate, and spending reforms could focus on improving efficiency and effectiveness in achieving the intended goal to the full, but also better management (rationalization) of spending. In order to achieve and maintain high economic growth, fiscal reforms need a convincing, coherent and well-structured design and a satisfactory fiscal space. However, little is said about the capacity and willingness of fiscal-budgetary reform for sustaining development. Therefore, the aspect of development is often analyzed from the point of view of ensuring the balance between the efficiency of a reform and the attainment of the objectives of social equity. At the same time, revenue-side reforms have lower chances of success (except for emerging and low-income countries, Akitoby, 2015) than those targeting the expenditure side. For example, a reduction in budget expenditures - more precisely the primary structural deficit - to about 4% of GDP over two years could lead to a 50% success rate of the consolidation reform (McDermott and Wescott, 1997).

In general, the idea of fiscal reforms starts from the fact that in the last decades the budget deficit and the public debt (accumulation of budget deficits) have increased substantially in almost all Western economies and the Eastern economies, although to a lesser extent, are also beginning to face more often with these problems. These developments are taking place against the backdrop of a consumer culture where growth in output and positive GDP growth are no longer equivalence at national level in raising general government revenues, and budget spending remains permanently over-proportional in relation to revenue.

Tax increases can be a short-term solution, but in the medium to long term it inhibits economic growth, a more agreeable solution, often considering reducing government spending in order to reduce the budget deficit. If government spending cuts could involve a recessionary phenomenon, then governments might be tempted not to do so in order to avoid companies bankruptcy and job losses for a large part of employees in that economy.

Like automatic stabilizers, when designing, implementing and adjusting them should be done in the economic boom and less in the recession period, fiscal consolidation reforms should avoid the direct testing in a strong and sustainable recession. In such a situation, fiscal consolidation measures could be detrimental to long-term growth, given that investment may remain low for an extended period of time. Also, fiscal consolidation in an unfavourable period (deep recession) could create the perception that some temporary revenue and capital losses could become permanent, and the business and employment behaviour of the workforce to be similar, creating that hysteresis phenomenon (De Long and Summers, 2012).

On the one hand, it is considered that the success of a fiscal reform implies integrating it into a wider reform framework that would provide the government with a sufficient credibility for the fiscal consolidation commitment. Structural reforms are an example of this, strengthening the labour market on employment, stimulating trade freedom and increasing labour productivity, as well as setting up new companies, supporting deregulation and increasing competition between companies.

On the other hand, the presence of tax reforms in a broad framework of reforms makes it more difficult to identify the impact of fiscal reforms on economic growth than in the case where tax reforms are not part of a reform package. Consequently, other reforms can play an important role in certain macroeconomic developments, developments first attributed to a tax reform. This can be explained by the fact that the existing analytical tools are still extremely limited in the clear delineation of the effects of fiscal policy reforms on other possible determinants. Furthermore, the complementary accompaniment of fiscal policy reform to other structural reforms enhances the consolidation of results and can determine the effectiveness of fiscal reform. Consequently, the isolation of tax reform and its results from the broad framework of theoretical and practical reforms would in some cases recommended be avoided.

Methodology and Data Sources

Although it is difficult to determine causality with certainty, the analysis suggests that the impact of fiscal reforms could raise per capita economic growth in medium and long term by ¾ percentage points in advanced economies and even more in developing economies. Moreover, when, in the framework of the reforms, the targeting of budget expenditures is made towards infrastructure investments, one could add ¼ p.p. economic growth (IMF, 2015).

At the same time, another dilemma relates to identifying where tax reform is the cause of economic growth or effect, a solution perhaps being the analysis of tax reforms or adjustments throughout the whole economic cycle (recession and expansion).

At the same time, an analysis before and after the start of the reform and its effect on: economic growth, debt/GDP ratio, unemployment rate, job creation, exchange rate, interest rates (short and long term) and on investment, can help shape conclusions about the effectiveness of fiscal reform on the economy in question. Therefore, the article attempts to outline this hypothesis from a few episodes of reform (regarding personal income) made in early 2010 (in countries such as France and Latvia with progressive taxation) and we will look at their possible correlation with economic growth, government debt developments (expressed as a percentage of GDP), developments in unemployment rates and long-term interest rates (according to Maastricht criteria).

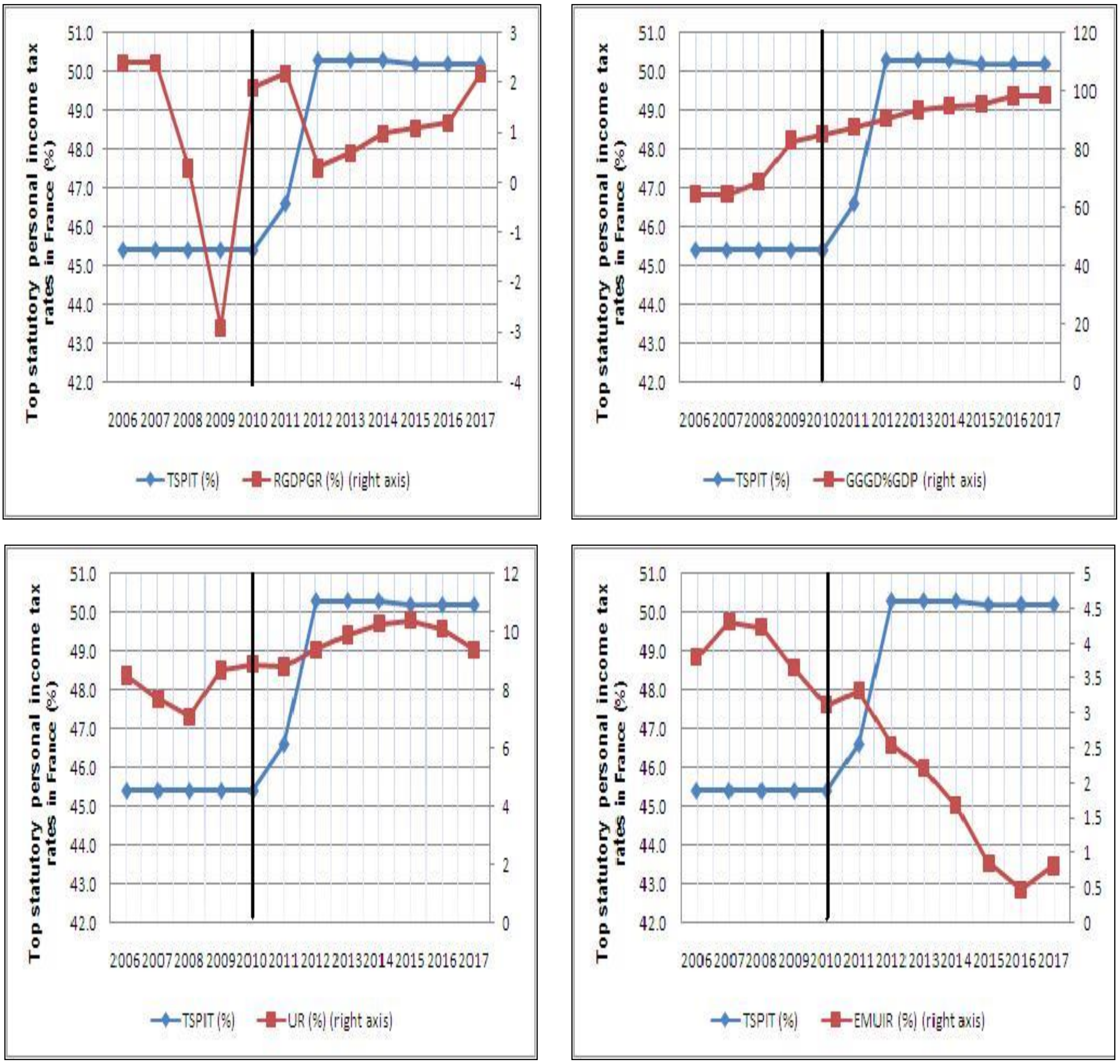
Results Obtained

According to the theory, strong economic growth helps to implement a successful tax reform with declines in public debt/GDP ratio, while poor economic growth with high interest rates reduces the chances of success of tax reform. Equally interesting is the reverse analysis, it would indicate whether fiscal reforms have the capacity to contribute to economic growth, reducing public debt, lowering the unemployment rate, stabilizing the exchange rate and interest rates (in this case, the present analysis is choosing long-term interest rates).

Given that at the end of 2010 and the beginning of 2011, progressive personal income tax has been improved in many EU Member States (such as France, Spain, Great Britain, Greece, Portugal, Latvia, Luxembourg, Ireland, etc.) but in many others has been reduced (e.g. Hungary and Denmark) (European Commission, 2011), we consider only two EU states: France and Latvia, with progressivity growth. The two countries are chosen: one to represent Western Europe and the other Central and Eastern Europe (New Member States). The choice of France was due to the fact that it increased the personal marginal tax as much as possible compared with other's member states, but also the taxation of capital income. Also, choosing Latvia was based on the rising of the upper rate (thus favouring the social equity function).

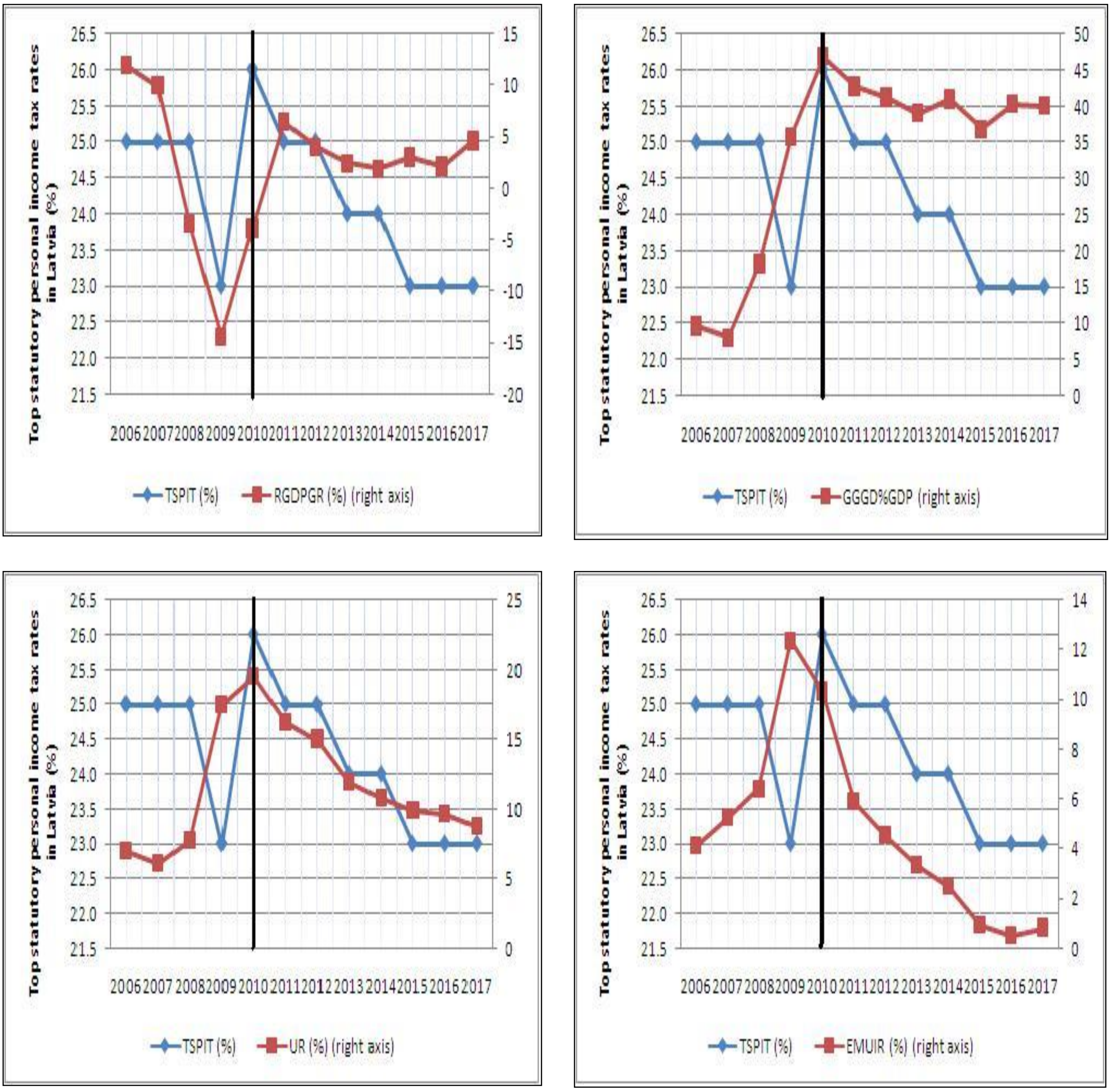
In the Figure 1 (for France) and Figure 2 (for Latvia) it can be seen that there are some connections between the top statutory personal income tax (TSPIT) and main macroeconomic variables choose for PIT reform responsiveness. Interesting is that the macroeconomic variables are anti-cyclical in report to economic growth rate but not regarding TSPIT. The black line is the mark for reform moment.

Figure 1. The connection between top statutory personal income tax and real GDP growth rate, General government gross debt (% of GDP), Unemployment rate (%) and EMU convergence criterion series for long-term interest rates (%) for France for 2006-2017



Source: Data from Eurostat, author's processing. The notation: TSPIT – top statutory personal income tax, RGDPGR - Real GDP growth rate – volume (Percentage change on previous year), GGGD%GDP - General government gross debt - annual data (Percentage of GDP) , UR - Unemployment rate by age (% of the labour force between the age 15-74) , EMUIR - EMU convergence criterion series for long-term interest rates - annual data (%) or Maastricht criterion bond yields (central government bond yields on the secondary market, gross of tax, with around 10 years' residual maturity).

Figure 2. The connection between top statutory personal income tax and real GDP growth rate, General government gross debt (% of GDP), Unemployment rate (%) and EMU convergence criterion series for long-term interest rates (%) for Latvia for 2006-2017



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Also for France the anti-cyclicality between TSPIT can be seen in report to EMU convergence criterion series for long-term interest rates (%) (See Table 1) and for Latvia in report to the General government gross debt (% of GDP) (see Table 2). For France, the strong correlation between TSPIT and long term interest rates might indicate also a great credibility of the French government in the international financial markets.

Table 1. Matrix of correlation between top statutory personal income tax and real GDP growth rate, General government gross debt (% of GDP), Unemployment rate (%) and EMU convergence criterion series for long-term interest rates (%) for France for 2006-2017

	TSPIT (%)	*RGDPGR (%)*	*GGGD (%GDP)*	*UR (%)*	*EMUIR (%)*
TSPIT (%)	1				
RGDPGR (%)	0.037250	1			
GGGD (%GDP)	0.835638	-0.107429	1		
UR (%)	0.846268	-0.013216	0.868928	1	
EMUIR (%)	-0.880030	-0.106628	-0.882299	-0.872450	1

Source: Data from Eurostat, author's processing using Excel Data Analysis

The notation: TSPIT – top statutory personal income tax, RGDPGR - Real GDP growth rate – volume (Percentage change on previous year), GGGD%GDP - General government gross debt - annual data (Percentage of GDP) , UR - Unemployment rate by age (% of the labour force between the age 15-74) , EMUIR - EMU convergence criterion series for long-term interest rates - annual data (%) or Maastricht criterion bond yields (central government bond yields on the secondary market, gross of tax, with around 10 years' residual maturity).

Table 2. Matrix of correlation between top statutory personal income tax and real GDP growth rate, General government gross debt (% of GDP), Unemployment rate (%) and EMU convergence criterion series for long-term interest rates (%) for Latvia for 2006-2017

	TSPIT (%)	*RGDPGR (%)*	*GGGD (%GDP)*	*UR (%)*	*EMUIR (%)*
TSPIT (%)	1				
RGDPGR (%)	0.243557	1			
GGGD (%GDP)	-0.254080	-0.387332	1		
UR (%)	0.202345	-0.578553	0.703699	1	
EMUIR (%)	0.422460	-0.639280	-0.026345	0.645902	1

Source: Data from Eurostat, author's processing using Excel Data Analysis

The notation: TSPIT – top statutory personal income tax, RGDPGR - Real GDP growth rate – volume (Percentage change on previous year), GGGD%GDP - General government gross debt - annual data (Percentage of GDP) , UR - Unemployment rate by age (% of the labour force between the age 15-74) , EMUIR - EMU convergence criterion series for long-term interest rates - annual data (%) or Maastricht criterion bond yields (central government bond yields on the secondary market, gross of tax, with around 10 years' residual maturity).

Conclusions

For the success of a fiscal reform, besides efficiency in communication, it is necessary to introduce measures or packages of compensatory measures for those who could be negatively affected by the provisions of fiscal reforms.

A series of tax reforms that may have a strong countercyclical character may be those that lead to progressive tax revenue growth, and in particular personal income tax and corporate tax. Thus, for the empirical study of the moment of reform, I took the year 2010, given that in the period 2006-2007 there were accumulated problems that led to the 2008-2009 economic crises. The countries analyzed were two states (one in Western Europe and one in Central and Eastern Europe): France and Latvia. They unleash progressive taxation and increased the progressivity during the analysis period (especially in 2010), with France registering an increase in TSPIT in 2010-2012 and Latvia a gradual decrease of TSPIT in 2010-2017. The anti-cyclical character of the two countries on the chosen variables is demonstrated in relation to economic growth, but the change in TSPIT is influencing negatively for France the long-term interest rate according to the Maastricht criterion, and for Latvia the gross public debt expressed as a percentage of GDP. The correlation matrices for the two countries demonstrate the above, but the results must be interpreted with caution due to limited data series.

It should also be said that although we cannot talk about the reverse correlations between TSPIT and the main chosen macroeconomic variables over the entire period, anti-cyclicality can be observed over shorter periods of time for both France and Latvia. Moreover, in both countries there is a progressive taxation and thus it is feasible that for other rates, beside TSPIT, to be registered a negative correlation with the indicators chosen for the analysis.

Tax reforms aimed at increasing the performance of automatic stabilizers are reforms of "fine tuning" or finesse, which imply insignificant or moderate but substantial economic growth from the perspective of translating the effects of growth into the economy (especially on the population and companies), the fineness of the fiscal “fabric" can direct, implicitly and naturally, the fiscal behaviour towards what may be considered desirable.

Against these backgrounds, we can notice that the new trends in fiscal developments certainly contain elements in the direction of greater responsiveness to economic cycle developments and to the greatest possible appeal to automatic stabilization mechanisms. For example, in the context of economic recovery, it is desirable to implement tax reforms that avoid pro-cyclicality. Furthermore, tax reforms should focus on aspects of enhancing social inclusion and protecting the environment. At the same time, it is necessary to move to progressive tax systems (especially regarding the taxation of personal income), which will ensure a better function of redistribution and relief of tax burden.

Future Directions to Be Approached

A future deeper analysis might be interesting from the point of view of social inequity, on the grounds that there are relatively ambiguous (some positive, other negative) statements in literature about the capacity of fiscal reforms to improve social equity, while others are clearly stating the rise in social inequity on the back of fiscal reforms.

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