World Applied Sciences Journal 22 (7): 964-968, 2013
ISSN 1818-4952

DOI: 10.5829/idosi.wasj.2013.22.07.3000

Fiscal Policy Effects on Economic Growth

Mariia Aleksandrova (Boiko)

Vadym Hetman Kyiv National Economic University, Kyiv, Ukraine

Abstract: Fiscal policy has been considered to be one of the most common and effective methods for state regulation of the economy in general and economic development in particular. Unfortunately, it has been reduced to state debt management or reactive economy policy during the last ten years. Due to contradictional specifics of fiscal policy impact on economic development for the long-run, there is a particular interest to the most and the least effective impacts on the economy for the long-run fiscal methods. Through statistical analysis was tested the existence and strength of correlation effects of fiscal policy on economic development. However, there is also a particular interest in the structural changes in the economy and stimulation of certain types of activity in the economy due to fiscal policy. These effects are better to be analyzed rather then statistically examined. Meanwhile, fiscal policy includes a wide set of tools for tax regulation, public procurement and redistribution of state and regional budgets. One of the most common tools, especially in Ukraine, is administrative regulation. Despite its strength, statistics show no link between such policy and GDP growth. Such results mean, that fiscal policy is mostly used ineffectively and has to be reconsidered.

Key words: Fiscal policy % Fiscal tools % Macroeconomics % State finance % Long-run effect % Statistics % Correlation analysis % Macroeconomic effects % State debt % Debt management

INTRODUCTION

Fiscal policy, if we consider it as a tool for long-term economy growth, has definite specific features such as reactivity (fiscal adjustment is in most cases a means of response to the current state of the economy), the complexity of the results prediction in the long-run terms (this complexity only increases nowadays due to globalization of the modern economic processes) and often unpopularity of some of its tools (tax regulation, for example, often becomes dependent on the political processes in the country). All this makes the most of the tools of fiscal policy ineffective or difficult to predict in the long-run.

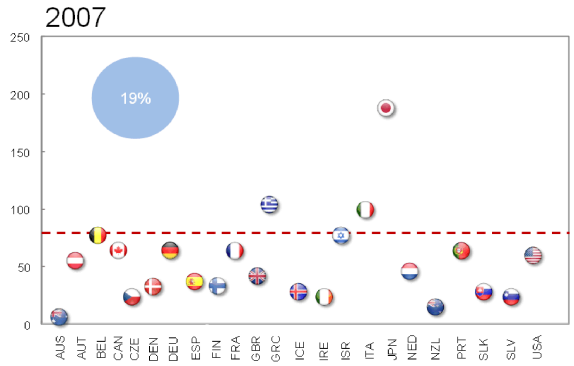
Meanwhile, fiscal policy is one of the most common and effective methods for state regulation of the economy in general and economic development in particular. This is a wide set of tools for tax regulation, public procurement and redistribution of state and regional budgets. Because of the diversity of its influence, their different intensity and duration, fiscal policy can actually provide the largest range of effects on the economy in the long- and short-run.

Due to internal contradiction of fiscal policy impact on economic development in the long-run, there is a particular interest to the most and the least effective impact on the economy for the long-run fiscal methods. The effectiveness of such actions is the actual subject of study in this article. Through statistical analysis we can identify the existence and strength of correlation effects of fiscal policy on economic development. However, we find particular interest in the structural changes in the economy and stimulation of certain types of activity in the economy due to fiscal policy. These effects can also be analyzed with statistical methods, but not only with them.

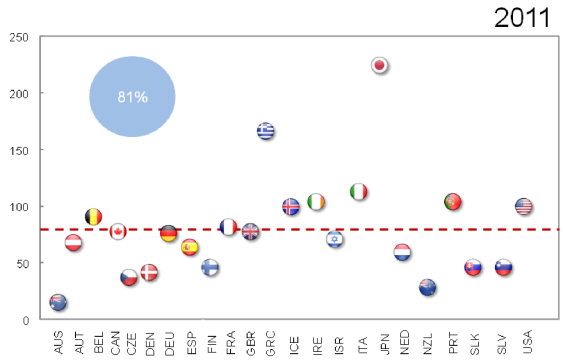
Thus, the most promising in the long-run are, in our opinion, those tools of fiscal policy, which lead to the structural changes of the economy. This thesis will be explored in this article.

Tools and Long-Run Effects of Fiscal Policy: It is widely agreed, that the long-run effects of fiscal policy are difficult to predict. “In the long run, there are so many additional factors (human capital quality, price level, initial economic stance, technological development etc) that influence economic growth. This is due to the fact that

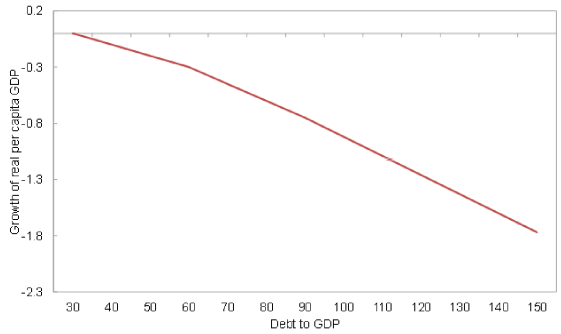
Corresponding Author: Aleksandrova (Boiko), Vadym Hetman Kyiv National Economic University, Tymoshenko St. 29, Apt 328, Kyiv 04205, Ukraine.



Graph 1: Advanced Economies: Debt Above 80 percent of GDP
Source: IMF [2]



Graph 2: Advanced Economies: Debt Above 80 percent of GDP
Source: IMF [2]



Graph 3: Effect on Growth of Higher Debt to GDP Ratio
Source: IMF [2]

not only the relationships of the same time period matter here but rather the consequences of the events of one period on the events of the following period. The longer the period, the more complicated it becomes to analyse the relationships between the events of the current period and the ones of the preceding and following periods. No theoretical model can perfectly explain why things are as they are."[1].

Today the problem has been widely increased with the high level of state expenditures, causing the state debt growth. The world financial crisis has revealed the discrepancy between state income and expenditure levels. It becomes evident on the following Graphs (1 and 2).

As we can see, modern developed economies would rather increase debt level, than reconsider expenditures. How does it affect the long-run economy growth? "

Spending control is vital before debt levels or tax increases cause severe permanent economic stagnation. Tax reform, with lower rates to be collected on a broader base of economic activity and of taxpayers, could also substantially increase incomes by 6% per year or more." (Altig *et al*. 2001, Jorgenson and Yun 2001) Furthermore, there is a proved correlation between GDP and state debt ratio (Graph 3).

On the other hand, is the GDP growth such essential for the long-run economy growth? We most often manipulate with figures, which leads to well-known dilemma: social benefits depend on taxation level or state debt increase, but economy growth is dependant on taxation level or taxation rate decrease. This dilemma can be depicted in real state fiscal policy.

For example, in Australia the Government has eliminated net debt and is continuing to strengthen its balance sheet by running budget surpluses and accumulating financial assets in the Future Fund. However, intergenerational fiscal pressures pose ongoing challenges for government finances over the longer term. By 2046-47, spending is projected to exceed revenue by around 3½ per cent of GDP.

These projections are based on a number of assumptions and the outcomes may vary depending on how events unfold and what policy choices are made. There are also risks which are difficult to quantify and unforeseen events which will have intergenerational consequences, such as pressures to address environmental issues.

The community faces choices in addressing these fiscal pressures:

Governments could run deficits and increase debt;
Taxes could be increased now or in the future;
Policies could be developed that support stronger economic growth; and/or
Spending growth could be reduced and spending made more efficient and effective.

Accumulating debt is not a sustainable long-term solution, particularly in situations where budget deficits are expected to continue for a period of time, since at some point the debt needs to be repaid. In addition, the compounding effect of interest costs would see net debt rise very rapidly, particularly beyond the projection period.

Policies that aim to support higher economic growth represent a preferred alternative. Higher growth per person directly raises the living standards of future generations of Australians. Growth also increases the capacity of the government (and individuals) to meet increasing demands for public services, not only arising from the ageing of the population, but also for better quality health care and other services.

The government can contribute to raising economic growth prospects by ensuring individuals face the right incentives and markets are able to function efficiently.

Another possible reason for government spending increasing with income could be because the public sector does not share in productivity gains experienced elsewhere in the economy. Both public and private productivity gains are important for addressing future spending pressures.

Given the uncertainty and risks, a prudent strategy to address intergenerational fiscal pressures is both to promote growth prospects and improve the efficiency and effectiveness of government spending. Governments also could consider the potential role of market-based mechanisms in managing spending pressures. Steps taken sufficiently early will avoid large adjustments later.

One way to assess the magnitude of the fiscal adjustment task is through its impact on the projected path of net debt. For example, an immediate increase in taxes or reduction in spending of around ¾ of a percentage point of GDP, maintained over the entire projection period, would see the level of net debt at the end of the projection period remain at around current levels. Alternatively, a reduction in the rate of growth in government spending of around 1/5 of a percentage point each year would also result in a similar outcome. However, these scenarios do not take into account the fiscal position beyond the projection period which will continue to impact on net debt [3].

Fiscal Policy and Administrative Impact: As seen below, the fiscal policy largely affects people's expectations and, therefore, programs future consumptions and investments as well. Huge national debt is a result of high level of social benefits, but has nothing to do with labour productivity decrease or investment capital outflow. It would be also interesting to measure indirect effects of fiscal policy.

Here, in Ukraine, the biggest problem for investors is the fiscal overregulation. In the World Bank rating, Doing Business, Ukraine is famous for one of the most complicated and expensive for business taxation systems in the world. This rating is based mostly on indirect indicators. But do they affect the long-run economy development less than the direct ones?

Doing Business provides a quantitative measure of regulations for starting a business, dealing with construction permits, employing workers, registering property, getting credit, protecting investors, paying taxes, trading across borders, enforcing contracts and closing a business—as they apply to domestic small and medium-size enterprises.

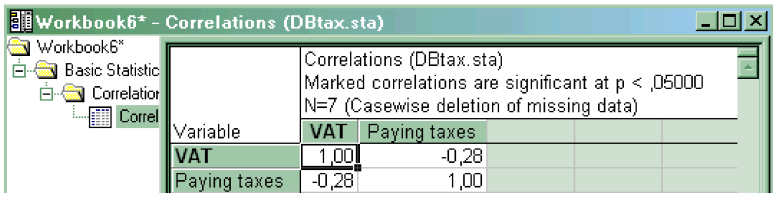
A fundamental premise of Doing Business is that economic activity requires good rules. These include rules that establish and clarify property rights and reduce the costs of resolving disputes, rules that increase the predictability of economic interactions and rules that provide contractual partners with core protections against abuse. The objective: regulations designed to be efficient, to be accessible to all who need to use them and to be simple in their implementation. Accordingly, some Doing Business indicators give a higher score for more regulation, such as stricter disclosure requirements in related-party transactions.

Some give a higher score for a simplified way of implementing existing regulation, such as completing business start-up formalities in a one-stop shop.

The Doing Business project encompasses 2 types of data. The first come from readings of laws and regulations. The second are time and motion indicators that measure the efficiency in a regulatory goal (such as granting the legal identity of a business).

Doing Business does not assess the strength of the financial system or financial market regulations, both important factors in understanding some of the underlying causes of the global financial crisis.

Doing Business does not cover all regulations, or all regulatory goals, in any economy. As economies and technology advance, more areas of economic activity are being regulated. For example, the European Union's body of laws has now grown to no fewer than 14,500 rule sets. Doing Business measures just 10 phases of a company's life cycle, through 10 specific sets of indicators. The indicator sets also do not cover all aspects of regulation in a particular area. For example, the indicators



Graph 4: Correlation matrix between VAT and taxation system regulation

Chart 1:

Doing business Ukraine	
Year	Paying taxes rating
2007	177
2008	177
2009	180
2010	181
2011	181
2012	183
2013	165

Chart 2:

	VAT, billion grn
2006	544153
2007	720731
2008	948056
2009	913345
2010	1082569
2011	1316600
2012	1408889

on starting a business or protecting investors do not cover all aspects of commercial legislation. The employing workers indicators do not cover all aspects of labour regulation. Measures for regulations addressing safety at work or right of collective bargaining, for example, are not included in the current indicator set [4].

As we can see, Doing Business rating depicts all stages of normal business cycle of a company. These stages reflect the administrational state impact on business and can describe how regulations affect the gross product. According to the methodology of the rating, the figures are based on the previous year's results. Let's explore the correlation level between taxation rate and GDP regarding one-year lag between these figures.

Evidently, there is no link between the indirect impact of taxation and VAT level in Ukraine. Such correlation level has three consequences:

- Direct methods of fiscal policy are way more effective than indirect,
- Ukraine, as most of developing countries, hasn't used all the opportunities of indirect fiscal tools,
- Most of taxation tools except for state debt management aren't used in a proper way.

CONCLUSION

Due to international financial crisis, fiscal policy is now mostly reduced to state debt management. Fiscal policy has also become deeply reactive and, despite its primary objective, has to cover the recession consequences rather than program the future economy growth.

The correlation test has shown that indirect fiscal tools are insignificant for long-run economy growth for developing countries (such as Ukraine). This also means that fiscal tools haven't developed all their potential yet. It has become evident, that fiscal policy must be used for modeling the future economy growth instead of covering the faulty decisions of the previous periods.

REFERENCES

1. Kalle Kukk, 2012. Fiscal Policy Effects on Economic Growth: Short Run vs Long Run. TTUPWE, 167: 3-4 http://deepthought.ttu.ee/majandus/tekstid/TUTWPE_07_167.pdf
2. International Monetary Fund, 2012. Fiscal Policy in Advanced Economies: Fiscal Adjustment, Efficiency and Growth. http:// www.imf.org/ external/ np/ speeches/ 2012/pdfs/031312.pdf
3. The Treasury of Australian Government, 2007. Intergenerational Report/ http:// archive.treasury.gov.au/ documents/ 1239/ HTML/ docshell.asp?URL=05_Part_4.htm
4. Doing business report, 2010. Reforming through difficult times. Published: September 9, 2009. http:// www.doingbusiness.org/ reports/ global-reports/ doing-business-2010/
5. International Monetary Fund, 2010. Will It Hurt? Macroeconomic Effects of Fiscal Consolidation, World Economic Outlook. http:// www.imf.org/ external/ pubs/ft/weo/2010/02/pdf/c3.pdf

6. Johannson, Asa, Christopher Heady, Jens Arnold, Bert Brys and Laura Vartia, 2008. Taxation and Economic Growth: OECD Economics Department Working Paper. http:// ideas.repec.org/ p/ oec/ ecoaaa/ 620-en.html
7. Lucas Robert, 2006. Analytical Foundations of Supply-Side Economics, Oxford Economic Papers. http:// www.jstor.org/ stable/2663227
8. Christina and David Romer, 2010. The Macroeconomic Effects of Tax Changes: Estimates Based on a New Measure of Fiscal Shocks, American Economic Review, 101(3). http:// www.aeaweb.org/ articles.php?doi=10.1257/aer.100.3.763
9. Nikos Benos, 2009. Fiscal policy and economic growth: empirical evidence from EU countries. http:// mpra.ub.uni-muenchen.de/19174/
10. Fiscal Policy in Advanced Economies: Fiscal Adjustment, Efficiency and Growth, Fiscal Affairs Department, IMF, March 2012/ http:// www.imf.org/ external/ np/ speeches/2012/pdfs/031312.pdf
11. Carlo Cottarelli and Laura Jaramillo, 2012. Walking Hand in Hand: Fiscal Policy and Growth in Advanced Economies. http:// www.imf.org/ external/ pubs/ ft/ wp/ 2012/wp12137.pdf