International Journal of Economics, Commerce and Management
United Kingdom ISSN 2348 0386 Vol. X, Issue 11, Nov 2022

http://ijecm.co.uk/

THE EFFECTS OF FISCAL POLICY ON ECONOMIC GROWTH

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Abstract

Fiscal policy is of great importance in the development of the economy. In Kosovo and other countries, fiscal policy plays a key role in economic growth. The state of affairs and the prudence of fiscal policies are essential for the preservation of macroeconomic stability. Fiscal policy relates to government actions in changing the composition of public revenue and expenditure by managing aggregate demand to maintain a steady economic growth with relatively high employment without creating an inflation and without increasing public debt and a satisfactory balance of payments . Methodologically, this study makes a critical review to check whether the fiscal policy in Kosovo has achieved its purposes, such as reducing economic inequality, reducing regions of inequality, environmental progress, etc. The study shows that fiscal policy did indeed have an important role in economic growth and inequality reduction.

Keywords: Fiscal Policy, Taxes, Economic Growth, Budget Deficit, GDP

INTRODUCTION

As public finances form a field of research that deals with public revenue and expenditure problems in particular, the importance of the topic is reflected through the macroeconomic imbalances and lack of economic stability that Kosovo has faced in recent years. Fiscal policy refers to government's efforts to influence the direction of the economy through changes in taxes or expenditures. Optimal fiscal policy in Kosovo and in other developing countries plays a pivotal role in growth process and, hence, serves as a vital instrument for economic growth. The efficacy of fiscal policy in improving economic conditions in the long run is, however, a controversial issue and needs further investigation.

Recognizing the importance of sound fiscal policy, the present study explores the link between fiscal policy and economic growth for Kosovo's economy. The study also examines the effectiveness of fiscal policy in different political regimes. The study also imparts some policy recommendations for the development of sound fiscal policy in Kosovo. This study is the first empirical analysis on the "effectiveness of fiscal policy and its impact on economic growth" in Kosovo.

The rest of this study is organized as follow: Section 2 presents the summary of review of literature on the effects of fiscal policy on economic growth in different parts of the world. Section 3 presents the model specification and methodology. Section 4 represents the empirical findings and the last section provides concluding remarks and policy implications.

LITERATURE REVIEW

Mishkin (1991) defined the crisis as a disruption of financial markets, in which adverse selection and moral hazard problems become much worse, so that financial markets are unable to efficiently channel funds to those who have the most productive investment opportunities.

Clinton, et al. (2011) concluded that, if a fiscal package is very well designed, then pain only arises if the package suffers from an initial lack of credibility, and the length of the period of pain closely corresponds to the length of the period during which credibility needs to be established. If a fiscal package is designed, the long run gain could be much lower or even non-existent, as higher distortions and/or productivity offset the gains from lower real interest rates.

Finance science as an economic science began to develop from the first half of the 19th century. The thoughts of well-known theorists who have dealt with the most financial problems and have presented a finance science development, in addition to the concept and theoretical point of view, which has been foreseen to find both precision and application even in our day or theoretical whether in the practical aspect. Whereas theories in the finance field have begun to be reviewed since the 1930s, to continue with contemporary theorists who made a great contribution to the consideration of this sphere. (Henderson, 2007: 66).

We find public finances as a subject of interest to English authors from the 16th to the 19th century and the most renowned representatives are: Hobsi, Loku, Hjumi, Ricicardo and Milli.A large number of studies have focused on the role and impact of fiscal policy both in the theoretical and in the empirical context. In its 2006 publication, in his studies, he states that "fiscal policy can be used to control the production or to stabilize the swing in macroeconomic indicators, which coincides with the short-term monetary policy impacts "(Romer 2006)Also, if we want to see its role in the long run then we say that: fiscal policies and forms of debt financing affect the demand and overall supply of the economy.

Viewed from the historical point of view in terms of taxation, Hjumi supports the view that "tax obligations are obliged regardless of the benefits of the state" (Hjumi). While Adam Smith is limited to tax problems. Smith should first point out that he was devoted to reviewing the tax principles, which defines the characteristics and the transfer of taxes. In this controversy David Rickard is considered as the architect of the free market economy. In public finance policy is known for treating the tax system, tax burden, the consequences that cause tax burden, inciting and increasing productivity.

On fiscal policy, John Stuart Milli is also limited to tax issues, the principle of tax neutrality. His point was to release the minimum tax on existence, while from the aspect of the tax policy policy it is opposed to taxation with progressive rates.

TAXATION AND ITS IMPACT ON ECONOMIC GROWTH

Growth theories can be in current macroeconomics considered as fundamental elements enabling to explain the impact of key variables on economic growth. It is necessary to realize that taxation influences economic growth solely through its impact on individual growth variables, which are capital accumulation and investment, or human capital (Macek, 2014; Kotlán, Machová and Janíčková, 2011).

Dwenger (2009) states that corporate taxation lowers the return of invested capital and influences also the capital structure or the company's age. Dreßler (2012) claims that taxation determines the foreign direct investment (FDI) inflow and plays a significant role in the investor's decision making about the investment localization. It is necessary to realize that entrepreneur's investment decisions can be influenced by the labour taxation, too. Alesina et al. (1999) state that the main reason for this fact is that the growth of labor tax rate leads to the employees' effort to get salary increase at a same level (before the taxation). By this, pressure is created on companies to lower their profits, and consequently their investment, too.

A positive relations between investments into human capital and long-term economic growth were confirmed by many studies; see e.g. Teixeira and Fortuna (2003) or Jones and Manuelli (2001). Lin (2001) confirms that a positive dependency can exist between economic growth and taxation if revenues from taxes are used only for human capital accumulation.

Several studies deal with the issue of taxation impact on economic growth in the case of developed or less developed countries or in the conditions of openness see e.g. Palomba (2004). However, none of the available studies evaluates the impact of taxation depending on institutional conditions.

The impact of taxation and government spending on economic growth within institutional conditions

Fiscal policy, as a part of state's economic policy is characteristic by its basic aims among which definitely belongs the stimulation of economic growth. This policy is usually executed by changing the amount or structure of government spending and taxes. Gemmel, Kneller and Sanz (2011) state that the impact of fiscal variables on economic growth is ambiguous and depends on their nature. Concretely, the impact of distortion and non-distortion taxes, or productive and unproductive spending on economic growth. Distortion taxes and unproductive government spending decrease economic growth. Productive government spending will have a pro-growth effect only if they are financed by non-distortion taxes.

Institutional conditions

It is necessary to realize that traditional neoclassical growth models (Solow, 1956; Swan, 1956) explain the differences in income per resident by the accumulation of production factors. In these models there are then the differences among countries caused by exogenous parameters (e.g. total factor productivity). Romer (1986) or Lucas (1988) make technological progress and product growth in a stable state endogenous. They determine only mechanisms which explain in what way it leads to the growth (e.g. innovation, education, capital accumulation), but do not explain the reason why some countries are able to apply these growth incentives and others are not. North and Thomas (1973) state that these factors are not the sources of growth but they are the immediate causes of growth. Also the fundamental differences in economic growth are caused by the differences in institutions.

This paper is dealing with the influence of government spending and taxation on economic growth in the countries with different structure of institutions. Concretely, institutions connected with the quality of public administration, regulation quality, transparency, trustworthiness of fiscal policy or corruption level are important for this study.

Olson (1982) empirically confirmed that good government institutions are an important determinant of economic growth. According to the International Monetary Fund, IMF (2007), higher fiscal transparency (i.e. implementation of a more credible and predictable fiscal policy) leads to an easier access to the capital markets and also helps in preventing of economic crisis existence. Folscher, Krafchik and Shapiro (2000) claim that the institutalization of transparency in economic practice creates a demand for concrete types of government system. They consider these government system types as the key factor of anticorruption policy. Namely it is independence, effective audit systems, the implementation of the responsibility principle, the existence of the information system which provides accurate information. Djankov et al. (2003) point out that more transparent government enables the economies to solve economic failures with lower social costs. Brixi and Irvin (2004) mention that fiscal institutions – rules, practices, organizations of fiscal policy are the main determinants of quality decision making about the fiscal support of the economy.

Government spending and its impact on economic growth

Within the impact of government spending on economic growth it is necessary to realize that their impact depends on the fact if productive or unproductive government spending prevail (Kneller, Bleaney a Gemmell, 1999). Barro and Sala-i-Martin (2004) or Kneller, Bleaney and Gemmell (1999) among productive government spending incorporate e.g. investment into education and human capital, spending on defense, infrastructure or healthcare. Unproductive government spending are mainly social security contributions.

Further, it is necessary to mention the work of Tanzi and Zee (1997) explaining "Wagner's law". Wagner's law states that economic growth can lead to increased demand for government services and "welfare spending". According to this law, in fully developed countries government spending raise from three main reasons. (1) socio-political: e.g. social and health insurance; (2) economic: thanks to the science and technology the increased engagement of the state in technological projects is required; (3) historical: growth of government spending lead in the end to the government debt increase. Therefore, if these spending suppress investments or government spending into education, then the impact of total government spending cannot be pro-growth.

But only a very few studies research the productivity of government spending in the case of different institutional conditions. E.g. Butkiewicz and Yanikkaya (2011) evaluate the influence of government spending on economic growth, where they study how the government effectiveness influences the efficiency of government spending. They do not classify government spending into productive and unproductive a priori, but they divide countries into two groups according to the effectiveness/ineffectiveness of government institutions. The first finding is that government consumption has a negative growth effect for certain groups of countries. The negative pro-growth effect of this spending can be seen especially in developing countries with inefficient governments, whereas in developing countries with efficient governments this impulse is insignificant. Second finding is that capital spending have a positive pro-growth effect in developing countries with inefficient governments and also in developing countries as a whole. Generally, these two results mean that government efficiency (efficiency of government institutions) is an important determinant of the economic growth in developing countries.

Hypotheses

H1: Harmonization of Kosovo's fiscal policies with those of the European Union will create growth in economic development.

H2: The development of consolidated fiscal policies will increase the role of the private sector in the Kosovo economy.

METHODOLOGY

Using the data from BQK and Ministry of Finance, the study focuses on comparing economic growth and budgetary deficit fluctuations to past, proposed and assumed values. Analyzing the fiscal policies implemented by Kosovo, we reviewed the efforts and results that materialized in changes of GDP components, economic growth and overcoming high budgetary deficits.

For the achievement of the intended goals in this paper, the application of recognized standards of scientific research methods was indispensable. Also, in order to further clarify the approach to this research process, we have used our long personal experience in finance and accounting, which is related to the relevant knowledge about this problematic. During the study, contemporary scientific methodology and quantitative analysis methods were used. The methodology and methods used are:

Deduction - this method enables us to achieve the research goals, starting from the general and reaching the target, therefore, a particular one. In this case, the functioning of the value added tax system, which is applied in most countries of the world in general, has been studied and analyzed, and the fiscal policy analysis in Kosovo and in the region has been a particular focus.

Descriptive - here are gathered different materials and reports that have been taken with the study of taxes in general and with the value added tax in Kosovo, in particular. In this case, literature was used by various local and foreign authors, as well as reports, studies from various agencies and researches published by organizations dealing with studies of this sphere.

SUSTAINABILITY OF PUBLIC FINANCE AND TAX SYSTEM IN KOSOVO

Sustainability of public finances and sound fiscal policies has always been the main objective of the Government of Kosovo. In order to maintain the sustainability of public finances, Kosovo has adopted a fiscal rule that limits the overall deficit to 2% of GDP in order to predict the state debt path to stabilization levels below the threshold set by law.

Moreover, in 2010, the Government has set the debt-based debt limit to 40% of GDP and also recently adopted a wage rule that sets a threshold over public wage levels in order to limiting the possibility of increasing public wages during the election years. In addition, the debt sustainability analysis conducted in this section assesses the effect of changes in macroeconomic variables over debt levels. Therefore, the analysis shows that there is no risk of disturbance on future debts, although this analysis is based solely on the assumption that the deficit level will be limited to 2% of GDP, despite possible changes in the structure of budget expenditures. According to demographic projections conducted by the Kosovo Agency of Statistics, the population structure is not foreseen to change to a considerable extent by 2060. Currently, the population in Kosovo is very young, with an average age of about 28.2 years 2017 and with a population of between 15 and 65 years that makes up more than half of the population. Population projections show that in 2060 the population structure will not change significantly by 58% dominated by the population within the range of 15-65 years of age and the population over the age of 65 represents 29% of the population. The current pension system in Kosovo operates through two pillars:

Pillar I or the basic old-age pension scheme, which is funded by the state and paid for each individual older than 65 years old, and Pillar II which is fully funded by the mandatory pension scheme that obliges all employers and employees contribute each with 5% of 46 gross wages. This fund is managed by the Kosovo Pension Savings Trust (KPST) and these assets are mainly invested abroad by well- known European asset managers.

Given that Pillar II is fully funded, the risk for the sustainability of the pension system is not foreseen to be large. Funds absorbed in the 2018 budget for financing Pillar I of the pension scheme amount to about 211 million euros or about 3.5% of GDP. In 2014, parliament passed the pension law where some changes to the basic pension were introduced for beneficiaries who contributed to the former pay-as-you-go scheme. For this purpose, MLSW has issued an administrative instruction which describes the criteria of education and experience as the basis upon which the rate of pension benefit will be determined. The additional cost for the budget for these changes amounts to about 23 million euros a sum that is already included in budget appropriations 2018.

Debt Sustainability Analysis

Kosovo's State Debt rate remains relatively low by the maximum allowed rate by law, so the risk of debt disturbance remains moderate. However, the current debt ratio is low, in part, a result of the short history of debt issuance and does not necessarily result from appropriate debt-approved government policies.

However, for the first time in 2017, the government adopted a fiscal rule that limits the overall deficit to 2% of GDP with the aim of stabilizing the debt ratio below the threshold allowed by law (eg 40% GDP). Given the low level of debt to GDP and the existing infrastructure bottlenecks with which the country is facing, in 2015 the government approved the 'investment clause' that allows the government to finance additional projects to improve the funded growth by IFN. For this purpose, the DSA (daily living expenses) conducted in this section outlines two main scenarios, namely the baseline scenario and scenario of the investment clause. The purpose of further analysis is to present the debt sensitivity analysis with changes in the underlying macroeconomic indicators. Kosovo DSA was conducted using the vehicle developed by the macro unit within the Ministry of Finance. To make the analysis, some assumptions have been made on the indicators macroeconomic basis and debt indicators. Debt levels have been reviewed using risk indicators drafted by the World Bank, IMF for countries in the mid-range policy implementation. The debt indicators and the debt threshold burden compiled by the BB-IMF and the percentage of debt-limited by law are as follows: Net present value (VAN) of debt to GDP - 40% VAN of Debt for Export of Goods and Services - 150% VAN of Debt on Budget Income - 250% VAN debt servicing for export of goods and services 20% VAN Debt servicing for budget revenues - 30% Assumptions on macroeconomic and debt indicators are as follows: Nominal GDP growth of 6.0% - Export shares to GDP increase by 0.2 p.p. The commercial loan interest rate is 5%. New concessional interest rate on credit is 0.75%- Commercial loan matures after 5 years Concessional loans mature after 10 years. The share of commercial credit from the total of new borrowing increases from 50% in 2015 to 70% in the following year The banking balance to GDP is 4.5% The overall deficit to GDP is 2% Budget revenues at 24% of GDP

Tax system in Kosovo

The Republic of Kosovo has applied a tax system focusing on the most advantaged international practices, as the orientation of the tax system construction in Kosovo were those of the systems as sisters of EU countries. Knowing our orientation and strategic and practical goals that Kosovo has to become members of the EU and EU institutions then our unilateral fiscal policy is aligned with the EU legal basis. This orientation on the construction of STK, especially as a base, has received taxes and customs policies (Direct and indirect taxes).

The Kosovo Tax System as well as the systems of developed countries is constructed in a range of laws and other by-laws, STK comprise these normative acts:

1. Personal Income Tax (TAP)
2. Corporate Income Tax (TAK)
3. Value Added Tax (VAT)
4. Customs Obligations

5. Avoid double taxation
6. Special Provisions
7. Transfer Pricing
8. Excise
9. The document is based on relevant applicable laws and is implemented by the Kosovo Tax Administration and Kosovo Customs.

DISCUSSION OF KEY FINDINGS & CONCLUSIONS

In dealing with this topic, I have focused and I have made a modest contribution by trying to describe and link fiscal policy with concept, philosophy, strategy to other indirect factors related to fiscal policies. "Fiscal Policies and Kosovo" is a topic addressed in several dimensions and has ample arguments in terms of finances and their strategy in drafting fiscal policies.

Countries in transition, transition as a concept and its impact on fiscal policies is another pillar I have designed in this topic, where I have described the factors and the developments of this sphere, explaining privatization as one of the key issues of transition from concept social market economy and the transfer of responsibility and property from society to the individual. Kosovo's economy faces a high unemployment rate today, which poses a challenge for economic recovery and economic development. Creating new jobs in Kosovo will be a little bit of a matter of concern for local politics, and I think that Kosovo's financial policies should be oriented in this area. Harmonization of fiscal policies affecting economic development has emerged as the core recommendation of this paper, as our country has not yet been able to overcome the transition problem, when it is known that the privatization system has not brought almost anything to the development process. Kosovo needs to build an economic system that has a favorable environment for local and especially foreign investors, in order to have an economic integration in the region and beyond, where economic development will be based on encouraging partners from the world economically developed. Budget deficit and potentials for its coverage are direct governance challenges, and as such should be considered that affect inflation growth, and the latter negatively affects the growth of the local economy by disorienting the market and the price index, and hence will spoil the balance between supply and demand.

RECOMMENDATIONS

Fiscal policies are built in such a way that the state can realize its interest based on the power of the total revenue it plans and can realize, where the primary objective is the welfare of the citizens and economic development, being aware that expenditures and taxes directly affect the economic development of a country and represent the real power of its national economy. The state should urgently join all revenue agencies in a central institution that collects and coordinates revenues, thus establishing the Central Revenue Agency. Build fiscal policies that foster investment and economic development. Develop an uncompromising fight in reducing tax evasion and informal economy by formalizing businesses and creating incentives for honest businesses and citizens who pay and receive a fiscal coupon. I recommend that the government and its agencies engage on behalf of the public debt to receive funds from international financial institutions and governments of different countries, while on behalf of the domestic debt to issue securities in order to increase the income for the budget. These funds are intended to finance strategic projects that have an impact on the economic development of the country. Harmonize fiscal policies with good governance as a key and source of common good. Capacity building of the Kosovo Tax Administration and its digitization is another priority which will enable businesses, citizens, and especially foreign investors to know and have online access to obligations and facilitations.

This study provides an important literature contribution regarding nexus between fiscal decentralization; however, the realization of this research has encountered some important limitations. Most importantly, there is no source of detailed information that would enable us to conduct a more sophisticated analysis out for the entire region through which we would be able to prove with greater certainty the possible economic effects of fiscal policy on economic growth.

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