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Professional paper

THE IMPACT OF FISCAL POLICY ON ECONOMIC GROWTH IN THE REPUBLIC OF NORTH MACEDONIA

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Abstract

How fiscal policy can affect economic growth are tax burdens and government spending.
The paper aims to investigate the impact of the fiscal policy on economic growth in the Republic of North Macedonia.
The main thesis in the paper is that there is a positive impact of fiscal policy on the economic growth of the country.
The budget deficit, public revenues, and public expenditures have their impact on economic growth.
This thesis is formed based on various theoretical postulates and research on this topic. Both quantitative and qualitative methods are used to examine the thesis. The paper will examine the type of that influence, i.e. whether it is positive or negative.

Keywords: fiscal policy, public expenditures, public revenues, economic growth

Fiscal policy concept

Fiscal policy is one of the essential economic terms. Fiscal policy is led by the legislative and executive authorities. Its significance is reflected in the aspect of collecting public revenues intended for financing public expenditures. Public revenues should correspond to the planned public expenditures, and their compatibility should be by the macroeconomic policy. The fiscal policy is an instrument of the government for creating policies at the micro and macro level, and the state provides the revenues through taxes and other types of revenues, which are alimony in the budget and other public funds to cover public expenditures according to the created fiscal policies.
Fiscal policy is considered to affect economic stability and economic growth in all market economies.
According to Siyan and Adebayo (2005), fiscal policy is an important instrument of the government to achieve macroeconomic stability in economically developed countries. A large number of authors emphasize that fiscal policy and public spending is the main variable that affects economic stability and sustainability. It has the role of a supporter of intensive and dynamic economic growth in market economies (Perroti, 2004; Ocnean, 2006; Woo, 2010; Mashkoor et al, 2010 in Kalash, B. and Miloshevich S.). Fiscal policy is defined by Rena (2006) as a way for the government to adjust the consumption level to monitor and influence the national economy.

The objectives of fiscal policy

The goals of fiscal policy are achieved through its impact on aggregate supply and consumption, and these are three:

- stabilization,
- redistributive and
- provision of public goods.

Stabilization: The objective consists of the efforts of the fiscal policy to reduce unemployment, maintain a stable level of prices, and a balanced balance of payments in the country. In other words, fiscal policy aims to bring real GDP closer to potential.

In pursuit of these goals, there are:

- restrictive fiscal policy - in situations when the economy is in the phase of expansion, due to inflationary pressure the state should lead control so that it does not turn into a strong expansion, by slowing down economic activities: reducing public consumption to mitigate the impact on prices and increasing taxes or by combining those two solutions. Each of the attached methods leads to a decrease in aggregate demand, that is, a shift of the aggregate demand curve to the left, and in the short term, there is a decrease in real economic output, a decrease in the general level of prices and a slowdown in economic activity. If the state decides to reduce public consumption, then, at the same time, a decrease in aggregate demand occurs, because state demand is an integral part of aggregate demand. Increased taxes, on the other hand, imply capturing a larger part of the income of households and enterprises. The third way is a combination of the previously noted two. All this results in a budget surplus.
- expansionary fiscal policy – as a measure, one goes towards increasing public consumption, reducing taxes, or a combination of both possibilities, to increase aggregate demand and revitalize economic activities to overcome the recession. All this results in a budget deficit. - Fiscal policy has a redistributive function in situations where a market distribution of income is needed, that is, redistribution of the national income between different social and social strata in the country is carried out, to ensure greater equality. Redistributive steps can also have opposing goals, so a balanced approach is necessary. If it is taken away from the income of the rich - they can be disincentivized for bigger undertakings, and if it is given to the social category there is a possibility that they will be satisfied with the social income and not be stimulated to work.
- Providing public goods is one of the roles of the state, as is the case with public administration, judiciary, security, defense, external cooperation, health and education, etc.

Literature review

Fiscal policy through public revenues and expenditures offers vital tools for economic growth. Both groups of variables have an impact on the level and size of national income through aggregate demand. Public (government) demand for goods and services and investment are necessary factors for economic stability and the level of full employment in the economy (Halkos, G., & Paizanos, E., 2015).

In a period of inflation, fiscal policy implies that the level of national income is lower than the point of full employment, so it is possible to move the aggregate demand to a higher point through public expenditures, the increase in public demand for goods and services, an increase in the demand for factors of production, and as a result the national income can increase (Ozer, M., & Karagol, V., 2018). The multiplier and accelerator can affect the level of national income, and that effect depends on the state of economic activity, so the total effect of fiscal policy on the level of national income has direct effects on the size of public expenditures and revenues (Rosoiu, I., 2015).

In most countries, especially in developing countries, fiscal policy is a key factor in shaping the direction of the economic cycle (procyclical), public expenditures increase and taxes decrease in economic prosperity, and on the contrary, public expenditures decrease and taxes increase in economic recession (Alesina, A. et al. 2008). On the other hand, higher tax rates may lead to higher levels of public expenditures, some of which may stimulate economic growth (Stoilova, D., 2017).

In addition, there is confirmed evidence that fiscal discipline has a negative effect on economic growth in the short term, and at the same time increases in the tax multiplier tend to be larger than cuts in public expenditure (Van der Wielen, W., 2020). This means that fiscal policy has a significant and direct impact on the level and structure of output and income through changes in public expenditures and taxation.

Most of the research results show that fiscal policy is a key cause of economic growth in the short and long term (Ozer, M., & Karagol, V., 2018), also there is a significant relationship between public expenditures, tax revenues, and economic growth in most countries. Empirical evidence reveals a weak but still vital link between fiscal policy and economic activity (Halkos, G., & Paizanos, E., 2015).

Other results reveal a positive causal relationship between fiscal policy and economic growth (Benos, N., 2009). A study by Easterly and Rebelo, (Easterly, W., & Rebelo, S. 1993) proves the importance of fiscal policy for economic growth, trade taxes and income tax in poor and developed countries, Ocran (Ocran, M. K. 2011) supports the significance positive effect of public expenditures and taxes on economic growth. Other studies confirm the positive effect of public expenditures and the negative effect of tax revenues on economic growth, (Almasaeed, A., & Tsaregorodtsev, E., 2018). Engen and Skinner (Engen, E. M., & Skinner, J., 1992) reveal a strong negative impact of public expenditures and taxation on economic growth. Public expenditures have a positive effect on growth, and tax revenues inhibit growth.

The relationship between public expenditure and economic growth is subject to change in the long run, as it appears to be cause and effect at the same time. Other studies show that the growth rate of public expenditure over time is the engine of economic growth (Angelopoulos, K., & Philippopoulos, A. 2007). The other point of view relies on the Keynesian model, which considers that public expenditure is a vital tool for fiscal policy that can accelerate economic growth (Loizides, J., & vamvoukas, G., 2005). Keynesians emphasize the positive effect of public expenditure on economic growth with the multiplier effect, while neoclassicals argue that the negative effect of public expenditure on economic growth will occur in the economy. An expansionary fiscal policy on public expenditure will lead to a crowding out effect, and crowding out between private and public activities will increase interest rates and tax rates, and as a result, economic growth may eventually collapse (Alqadi, M., & Ismail, S., 2019).

The role of public expenditure in stimulating economic growth is a matter of debate in developed and developing countries (Lindaue, D. L., & Velenchik, A.D., 1992). Empirical research has proven contradictory results, for example, some studies show that the effect of public expenditure on economic growth is insignificant (Lee et al., 2019). Hsieh and Lai (Hsieh, E., & Lai, K. S., 1994) found that public expenditure has a small proportion of economic growth, while Saez's study (Saez et al., 2017) suggested that public expenditure and economic growth have no significant relationship in EU countries, but other studies have confirmed the key role of public expenditure in economic growth (Nguyen, H. H., 2019). Wu et al. (Wu, S.Y., Tang, J. H., & Lin E. S., 2010) strongly support Wagner's law which states that public expenditure is a beneficial factor for economic growth and the causal relationship between tax revenue and economic growth is also proven (Canicio, D., & Zachary, T., 2014).

The positive effect of expenditures and the size of the public sector on economic growth is proven (Diamond, J., 1989).

To assess the role of fiscal policy in the economy, the literature has shown that there are different views on which variable best represents fiscal policy. While many researchers have used tax as a proxy for fiscal policy (Dladla, K., & Khobai, H., 2018). Other researchers used the budget deficit in their estimates (Shihab, R. A., 2014). Other studies used public expenditures (Halkos, G., & Paizanos, E., 2015 ;). Some studies have divided public expenditure into different components (Cyril, U. M., 2016). Researchers argued that there is no strong correlation between the three political variables and economic growth when studied individually (Ocran, M. K., 2011). Most of the literature on fiscal policy and economic growth tries to examine the two instruments of fiscal policy, namely public expenditure and taxation simultaneously (Ibid).

Impact of fiscal policy

In the short term, the fiscal policy affects the real output, and the budget expenditures have a multiplicative effect on the gross domestic product, which would imply, according to the principle of the multiplier, that every denar spent from the budget leads to an increase of the gross domestic product by more than one denar.

Hence, it can be determined that the fiscal policy has a multiplier effect on the gross domestic product. Scientific results show that the multiplier is higher when the government directly increases expenditures, and lower when the government lowers tax rates, i.e. one spent denar for the government implies a direct addition to the gross domestic product, and when taxes are reduced, part of the taxpayer's income is released and, in that case, only a part will be spent on the population sector, and the rest will be saved.

When the government proposes and implements changes in tax rates and public spending programs, depending on the phases of economic cycles, we are talking about discretionary fiscal policy. Such a stabilization fiscal policy is implemented to avoid unwanted consequences of economic cycles, i.e. expansion, i.e. recession. In situations where we have a recession, the government has the right to propose and request to the legislature a reduction in tax rates and an increase in public spending or a combination of both measures, to increase aggregate demand and overcome the recession.

In situations, however, when we have expansion, the government should act contrary to the above. Many macroeconomists think that governments have a legitimate right in situations of expansions or recessions to implement discretionary fiscal policy to stabilize the economy. However, some economists believe that discretionary fiscal policy also has certain limitations or weaknesses that hinder efficiency and even lead to counter-productiveness.

Fiscal policy can have short-term and long-term effects on macroeconomic aggregates. We can see the short-term impacts of the fiscal policy if we consider a situation where the state leads an expansive fiscal policy. In that case, tax rates are usually reduced or public spending is increased, or a combination of both measures.

In that case, the following can happen in the economy in the short term: - The aggregate demand increases, which will cause an increase in the gross domestic product, that is, a decrease in unemployment, etc.

- The growth of production leads to an increase in the demand for money and also to an increase in the interest rate.
- With an increase in the interest rate, there is a decrease in aggregate demand, in those segments that are sensitive to the height of the interest rate, such as investments in the private sector, then the consumption of durable goods by the household sector, etc.

Consequently, as a consequence, we have a decrease in the real gross domestic product and a decrease in employment.

- What does this show? That the effects of expansionary fiscal policy have short-term effects on the real economy.
- When the interest rate increases, the value of the domestic monetary unit also increases and thus domestic products and services become more expensive.

This, in turn, leads to a decrease in the country's exports (Fiti, T., 2016).

As can be determined from the previous, the effects of the expansionary fiscal policy in the longer term are limited by the increase in the interest rate. In the long term, the expansionary fiscal policy causes an increase in budget deficits and the accumulation of public debt, leading to crowding out (Ibid.). Empirical research on the impact of fiscal policy claims that the government through the instruments of fiscal policy has a strong influence on economic growth.

Analysis of the situation in RNM - historical overview

The fact of importance of fiscal policy in maintaining the macroeconomic stability of a country is generally known in economic science. The Republic of North Macedonia, from the period of its independence as a state, faces a series of challenges about the application of fiscal policy.

Namely, in the so-called transitional period, which does not yet have clear boundaries for its completion, Macedonia, despite all the challenges, domestic, external, economic, or non-economic, still manages to maintain macroeconomic stability, and one of the policies that play a significant role in this context is precisely the fiscal policy.

At the very beginning of the so-called transition period, the Macedonian economy faced a high rate of inflation and a high level of budget deficit. One of the measures taken by the then government was the adoption of the Stabilization Program in 1994, to apply various measures of a fiscal nature. As a result of those measures, there has been a decrease in budget expenditures and, analogously, the budget deficit. In 1994, the budget deficit was 2.7% of GDP.

In 1999, the budget of Macedonia was in a balanced state. What is that due to? It is due to the increased state saving but in conditions of growth of the available income.

In 2000, we had a favorable economic atmosphere, and as a result, there was a further increase in disposable income, all while reducing public expenditures. Then, in conditions of a moderate acceleration of the level of public investments, we have a budget surplus of 2.6% of GDP. And, in the next two years, due to the drop in the disposable income of the state and the increase in public consumption, there is a result with a negative sign of walking.

Thus, in conditions of a relatively high level of investments of 3.5% of GDP, the budget deficit amounts to 6.3% and 5.6% of GDP in 2001 and 2002 (Kurtishi, Nexhat, 2013). After 2002, we have an improved economic situation, and as a result, the income available to Macedonia is growing. However, during that period, public consumption had a downward trend, which, in turn, caused savings again. In the period 2003-2004, we had a fall in investments equal to the savings of the state and thus we have a state of balanced budget. Furthermore, in 2006 we had a budget deficit of 0.5% of GDP – this is happening in conditions of a reduction in savings about public investments. The budget balance in 2007 is already positive – 0.6% of GDP – with an increase in walking, growth in disposable income, and reduction in public spending. In 2008, we had an increase in public investments and as a result, the budget deficit was 0.9% of GDP.

In 2009, we had a decline in the state's income, and stagnation in public consumption, with savings reduced to 0.6% of GDP, and thus the budget deficit reached 2.7% of GDP, which is in a state of realization of capital expenditures of 3.3% of GDP (Ibid.). In 2010, the disposable income decreased, and in 2011 it was 9.4% of GDP. In this period, we have a decrease in public consumption and an increase in savings, which, in turn, results in the growth of public investments, which implies a negative gap of 2.4% of GDP in 2010 and 2.5% of GDP in 2011. (Ibid.). In the above paragraphs, we presented the picture of the movement of the budget balance in the so-called transition period in Macedonia, and in the following, we will briefly present the state of budget expenditures from the RSM budget, as an instrument of fiscal policy.

Let's see what the state of budget revenues is like. They, analogous to the expenses, after the period of independence of the state, are high. In that period (1991 – 1994) the average income is 42% of GDP. In the following period, although seen in isolation as incomes, they increase, put about GDP we have a decline and in 1998 they amount to 33.3% of GDP.

Then, in 1999, we had an increase with the same dynamics as in 2000, with budget revenues reaching a level of 36.6% of GDP.

During this period, the value-added tax (VAT) was introduced, and accelerated economic growth took place. Value-added tax is a substitute for sales tax. In 2001, we had changes to the legislation on personal income tax (PIT) and we had a decline in revenues based on PIT. But we also have a decline in revenues from indirect taxes, such as the goods and services tax. Then the tax on financial transactions is introduced, and as a result, a greater decline in tax revenues is prevented.

In 2002 and 2003 we have an increase in the absolute level of income and as a result, we have an increase in the fiscal burden which in 2006 will reach 32.5% of GDP. In 2007, we had an increase in income as a result of the increase in VAT income. In the following period, we have a reduction in the income tax rate to 12%, then the profit tax, which is equal to VAT. All this did not create negative fiscal effects. Revenues based on direct taxes are increasing by about 13%. We have high economic growth, which, in turn, results in positive economic movements, including the labor market.

In 2008, we had a growth in budget revenues of 33.1% of GDP. Then, the VAT and profit tax rates are further reduced to 10%. As a result, we have a 2.2% decline in PDD revenue despite wage growth. However, we have a positive reflection on the collection of social contributions with an increase of 14.3%. In 2009, we again had legal changes regarding the tax regulation, according to which only the profit from the distribution of dividends is subject to taxation. We also have a decline in economic activity, with a significant decrease in income based on profit tax of 48.3%. With the introduction of the gross salary concept, total budget revenues in 2009 amounted to 31.3% of GDP. Following the amendments to the legislation, in 2010, the rate of social insurance contributions was reduced to 27% and this resulted in a drop-in income on that basis.

Incomes, on the other hand, acquired based on the profit tax have a drop of 16.8% of GDP. We also have a decrease in the income from import duties. We have positive trends in revenues from VAT and excise duties and VAT. Thus, budget revenues in 2010 had an increase of 2.8% and amounted to 30.4% of GDP. In 2011, there was a growth of 3.8% in revenues and a decrease of 29.7% in GDP (Ibid.). Public debt is one of the instruments of fiscal policy. In the analyzed historical period from 1999, the public debt is 40.7% of GDP, and the debt from external sources is about 92%. In 2000, the public debt increased to 57%, which is a consequence of the issue of the so-called structural bonds.

In 2004, the public debt was reduced to 41.5% of GDP. That year is also marked by three-month and six-month government bills issued for the first time. They are an instrument for financing the budget deficit. In 2005, twelve-month government bills were introduced, as well as a government bond with a maturity of two years. That year, the first Eurobond was issued on the international capital market, and as a result, the public debt increased by about 45.5% of GDP. In 2006, we had a reduction in public debt to 38.8% of GDP, and a reduction in public debt in 2006 to 38.8% of GDP. In 2007, the public debt decreased to 32.3% and it is claimed that this is the result of the reduction of the external public debt. The state then repays the debt to the International Monetary Fund and the Paris Glob of Creditors. In 2008, the public debt was set at 27.8% of GDP.

What is the result of the reduction of the public debt? For the most part, the cessation of the issuance of government bills for monetary purposes, the reduction of the debt of the NBRM based on treasury bills, and the regular maturing of the structural bonds. In 2000, we had an increase in the public debt to 31.8%, as a result of the financing needs of budget operations, that is, the increase in external debt, and mostly due to the issuance of the second Eurobond on the international capital market. That year is also characterized by the fact that one-month government bills and government securities with a foreign exchange clause were introduced. In 2010, we had an increase in public debt to 34.8% of GDP. In 2011, public debt increased to 40% of GDP. This year is characterized by the fact that five-year government bonds were issued for the first time (Ibid.).

Conclusion

With the help of fiscal policy, that is, public revenues and expenditures, governments try to act on the basic macroeconomic aggregates, that is, on the total economic activity. The basic instrument of fiscal policy is the state budget, which has its own revenue and expenditure side. The budget receives public revenues from all types of taxes, including customs duties as a specific type of import taxes, as well as other public charges that must be paid by citizens and enterprises. The state is the only power that has the right to impose public charges on taxpayers. Through public taxes, modern states capture a significant part of the gross domestic product and thus redistribute income in the economy. The state budget spends collected public revenues in the form of public expenditures for a variety of purposes: salaries for employees in the public sector, etc. Through budget spending, governments can significantly influence the overall economic trends in countries. Increased budget spending in the short term has obvious implications on aggregate demand, and through it on GDP and employment. Through fiscal policy (public revenues and expenditures), governments can act anti-inflationary, when the economy is expanding, that is, anti-recessionary when there is a decline in economic activity. Under conditions of inflation, governments increase tax rates reduce budget expenditures, or combine both measures to curb inflationary tendencies. The reverse is done in times of recession. Then governments reduce tax rates or increase budget expenditures, that is, they combine the two measures to revive production and increase employment. Budget deficits, which occur when the government spends more funds than it has collected through public revenues, have a strong impact on savings, interest rates, and investments.

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