THE POSITIVE AND NEGATIVE ASPECTS OF FISCAL POLICY IN IMPROVING THE BUSINESS ENVIRONMENT

Stevan Gaber, PhD [1]

ABSTRACT

In time when the last serious economic crises in the world had made impressionable implications on the economies of the developed and respectively transitional economies, the role of the government have become once again, since the great depression, one of the crucial economic agents that could create positive circumstances for the private sector in order to surpass the current crises. The active government policy through expansive fiscal policy had made impressive step in helping the private sector in supplying them with demand for their services, easier access to funds, simplified administrative procedures and etc. Especially, the lack of capital on the international markets and the fall in international demand forced the governments to intervene and to pull the economy out of recession with intensive government expenditure. This paper focuses on the measures that the government took and tends to take in enhancing the entrepreneurship and specifically on the Macedonian government measures. These measures could help the private sector to overcome the recession and facilitate the economic activity towards increased production and export, but it must also take into consideration the other negative side of this expansive fiscal policy. Exactly the alternatives of financing those budget deficits, which are common in many countries, could initiate intensive borrowing from the government in order to finance those economic activities. Once again, since the '80-ties, these kind of financing is a reason for unstable and irresponsible growth of the public debt/GDP ratio from the governments. Although, majority of the countries tend to increase the capital investments, but the fact is that most of that money goes for government expenditure. Precisely that excessive government expenditure in most countries is the reason for "crowding out" of private investments. This paper states the borrowing process of the government and their massive demand for capital that puts the private investors in undermined position in comparison to the government which is able to supply the capital through higher price. In other words, this paper is analyzing the positive effects from the government actions and the negative implications that the deficit finance could cause. The final objective of this paper is to detect the implications that may cause the government with the revenue and expenditure side measures in order to help the private sector.

Keywords: budget deficit, public debt, public consumption, tax cuts, real sector.

[1] Assistant at University "Goce Delcev" - Stip, e-mail: stevan.gaber@ugd.edu.mk

INTRODUCTION

The fiscal policy is again the center of attention in the economic circles, since the last several years of active fiscal policies regarding the financial crises. The intensified government spending and reduced taxes had become initial instruments in the battle to prevent further decline in the nation's GDP levels and even try to neutralize the initial negative impact. Keynes had become once again, since the 1970-ties, in the center of world-wide discussions about the role of the government in the market economy. That active fiscal policy that recommends even accumulation of debt in order to stimulate the economy was applied by number of countries, especially those who already had enough fiscal space to do so. The others with high level of debts were found in uncertain conditions and try to react through monetary policy while in the same time were cutting on some excessive government expenditures and even raising taxes. In the first section of the paper, the attention is set on the instruments of fiscal policy and the potential measures that could contribute for better economic activity. The focus is set on several spending areas and on reducing some taxes in order to support the economy. The second section is analyzing the problem of several EU countries regarding debt sustainability as crucial element that had been used most often as source for getting out of the depression. The third section sets light on the fiscal policy measures taken in Republic of Macedonia which are in favor of improving the business environment.

INSTRUMENTS OF FISCAL POLICY

After the last serious economic crises, which started in housing and financial sectors, the consequences upon the economies were immense, registered through impressive fallback in the aggregate demand. So in case like that, again since the last "Great Depression" the way-out was in the concept of active fiscal policy in order to neutralize the negative shocks in the financial sector and in the level of national product. Again, it was on the fiscal policy through the implementation of fiscal instruments, such as tax cuts and increased government spending, to hold back the further decline in the aggregate demand.

In order to stop the negative tendency in the world economy, the IMF proposed intensive coordinative global fiscal stimulus that would depend upon the extent of decline in the private demand and intensive government response. Anyway, it must be taken into consideration that a lot of countries are not in position to force that kind of fiscal policy regarding their level of fiscal sustainability. The expansive fiscal policy would require budget deficits demonstrated with low taxes and high spending, and in terms of previous critical debt level would jeopardize the fiscal stability of the economy. This is especially the case of small and open economies which do not have easy access to capital, have high level of public and foreign indebtness, and high risk premia. In that case it is essential the bigger countries to take more important role in the potential fiscal package.

That kind of fiscal stimulations need to be timely (need for intervention), vast (since the drop in the aggregate demand is large), lasting (since the duration of the recession will be long), diversified (since there's uncertainty regarding the effectiveness of various measures), collective (every country will need to participate according to their capabilities) and sustainable (to avoid

debt explosion in the future and possible negative effects in the short run). In other words, spending measures are more effective then tax cuts, because the increase in transfers will provide additional purchasing power for the households with low income which are more recognized as consumer oriented economic group of subjects.

When we are considering public spending measures we think on *public spending on goods and services, fiscal stimulations for consumers and fiscal support for the enterprises.* In downturn the government needs to continue with the current programs without possibility for suspending their realization. This is especially the case where the government is obliged to fulfill the balanced budget criteria, which fosters restrictive prociclical fiscal policy focused on reducing public spending and increasing taxes. On sub-national level that could be surpassed by government transfers that could help in preventing spending program cut backs. Exactly that kind of spending would trigger bigger aggregate demand then the initial government order, expreesed as multiplier effect. The initial government demand would initiate increased production, work force and profit. Those paychecks will be used for providing goods from other enterprises in the economy. Final conclusion is that exist positive feedback between higher demand which leads to higher income, and in return higher demand. That would mean also new investment plans as response to the government demand. (Mankiew, 2008)

Although, government could also decide to increase the wages in the public sector, but it is shown that this measure is difficult to be reversed and is similar in effectiveness as transfers. Anyway, it is justifiable to boost public sector employment, if not temporary, with some new projects, such as accession in EU which needs additional force for fulfilling the new positions regarding the available funds coming from EU.

When comes to question support for the consumer in such exceptional circumstances the first argument is decline of wealth, which would lead the consumers to cut back spending; second, restrictive credit programs, described through difficult access to finances for suitable interest rate; and third, expected uncertainty which diverts people from consumption towards saving.

Another measure would be certain tax cuts. But it's not clear if the announced decrease in some taxes would give the required boost for consumption, since the marginal propensity to consume in such time is pretty low. Then there are some other measures, such as incentives for buying new cars in countries like Germany and France.

In the case of firms, they are the first one's that react in respect of fall in demand and stress out the potential negative implications immerging from government (re)actions. Also like the consumers and the firms intend to suspend any potential investment decision based upon uncertainty. It has been shown that short term cuts in corporate taxes have a small impact on the behavior of the enterprise. Another vital element, despite this positive measure of tax reduction, would be the fiscal policy direction. If the government decides to implement active, expansive fiscal policy, it is expectable to make some changes in the level of budget deficit. Now comes the crucial question which source will the government use to fund the private sector, since decides to lower taxes and increases the spending. That budget deficit will have to be covered from additional resources from domestic financial market or international markets (foreign debt). For many countries the insufficiency of capital on global market and high interest rates forced them to orient towards domestic markets. But the problem arises when those economies are small and

open, with low capital and have negative current account balance, fixed exchange rate regime and independent monetary policy. It is replicated as rise in interest rate due to intensive borrowing from the government, and finally reaction from the Central Bank in order to sustain and prevent drastic raise in credit price. In lot of development countries the Central Bank went on implementing restrictive monetary policy in order to contain the pressure on interest rates and announced vicious battle against speculative attacks on exchange rate and pressures for devaluation of the currency value. For example, in 2009 in Macedonia the government increased domestic debt through emission of 1 and 3 month government notes and it become competition to the treasury notes issued by the central bank, since both had the similar characteristics. The last were intended for regulating the money flow and the government notes for spending programs. This stressed out the necessity for coordinative approach between the monetary and fiscal policy in order to provide stable framework for macroeconomic policy. (Blanchard and Cottarelli, 2010)

The situation would be different in case of an open economy with flexible exchange rate mechanism. The active role of the government on the financial market would put pressure n the private sector, which in return is not able to follow the government lead in borrowing under higher interest rate. But that higher market interest rate would attract foreign capital and find destination as investment in domestic securities, and in return would cause appreciation of the exchange rate which will worsen the trade balance account. This situation is known as "twin deficit". Precisely that higher interest rate would be essential for development countries in servicing public debt depending of their external debt. (Langdana, 2009)

Even in the situation of financing the budget deficit through inflation, buying government bonds by the Central Bank and increasing the money flow, the firms would hold down to their expectations on future inflation and potential devaluation of real value of the debt. That's also risky, because firms will hold all the investment decisions in such unstable environment. That's another reason why the governments need to be in touch and cooperation with business sector in order to produce economic growth that could shadow the government borrowing costs, instead of accumulating new debt in case of GDP decline. So that's why the government should intend to find ways how to help the private sector (government guarantees on new credit, facilitated access to capital, etc.). Direct support through export subsidies is not recommendable, because it promotes policy of uneven playground for foreign companies, and potential retaliation and trade wars (bagger-my-neighbor policy).

DEBT SUSTAINABILITY ISSUES

When the government decides to give fiscal stimulations, it needs to make straight statement that the action will depend from the conditions in the economy. This is important from the aspect of financial markets, since they seek opportunities to question the medium term sustainability, which in return will have negative effects on the interest rates and consumer spending. That was the case in the European Union, where financial crises increased significantly the public debts. Starting from 2007-2011, the average debt ratio in Eurozone had increased by 10-60%. The four countries with the largest growth were Greece, Portugal, Spain and Ireland, faced with serious difficulties in respect of borrowing under better conditions on the financial markets. According to European Commission the main reason for debt increase was cyclical. Although, Ireland and Spain went into recession folding burst in the housing price bubble and eventually build up their debt. Also negative are the forecasts of the European

Commission regarding the negative output gaps through 2012 in Eurozone countries (1, 6% of GDP following the peak in 2009 from 3, 8%), with exclusion of Malta and Slovakia. But we should try to see other crucial factor which makes the indebtness situation severe and that is the ageing process in EU. A lot of EU countries are aware of this problem and had increased the age border for retirement, since the low fertility rates are not positive indicator for healthier nations caused by gradually higher health care costs. It is for sure that the low growth of countries output is sign for structural reforms in order to reduce public expenditures, such as paychecks cuts in public administration, reforms in pension systems, reforms in labor markets, improvement of the competiveness, etc.

In context of previous, it is necessary to make distinction between cyclical and structural deficits, because the first ones would rise in time of recession and decline in good times and the last in good times too. If the growth is satisfactory and the level of budget deficit small, it could be expected adverse effect on the level of public debt.[2]

But the situation is very different if budget deficits had become large and structural, the rate of growth with tendency to decline and high interest rates. That kind of fiscal policy would lead towards debt accumulation and increase of debt/GDP ratio. This situation started to prevail in the second half of 1970-ties and appears even today in EU. The debt explosion puts the politicians in front of a tough choice that could not be postponed or neglect. It is necessary the rate of increase of interest component in public expenditure to adjust some other costs or even increase for the same amount taxes. It is proved as politically difficult to raise taxes as adjustment to interest outflows and that's the reason for timely and corrective political decisions. (Gaber, 2011)

In the last 20 years, Finland, Ireland, Spain, Sweden have made a major step in reducing their debt/GDP ratio through rapid growth. The growth effect is visible through: 1) faster increase declines the ratio, under everything else unchanged; 2) the faster growth tends to raise tax revenues without forcing the government to raise tax rates as unpopular measure and allows the government to make some cutbacks on the spending side. That kind of growth is possible only in countries that are far from technology frontier and made major reforms in budget process. Some countries that are close to that technology border succeed in reducing their public debt through growth, but mainly from adopted reforms in fiscal institutions. (Belgium, Canada, Denmark, Sweden) This implies that economic growth alone is not enough to cut public debts. Though, the institutional reforms are inevitable in order to prevent constant deficit oriented fiscal policy. (Von Hagen, 2006)

THE FISCAL POLICY MEASURES IN FAVOR OF ENTERPRISES IN REPUBLIC OF MACEDONIA

The limit in monetary policy in case of financial crises shifted the response to the fiscal policy trough coordinative approach directed to two areas: 1) enhancement of financial sector; 2) increase in the aggregate demand. As the rest of the countries in the world, Macedonian fiscal authorities were set in front of hard challenge – to turn towards fiscal stimulations which would facilitate the consequences of the financial crises and intercept the decline in economic growth and unemployment. They were pointed in two directions:

- Tax reforms (decrease of taxes, social contributions, custom duties)

[2] This was the case of USA after the World War II and 1970-ties.

- Increase of public expenditure (infrastructure projects, capital investments).

The fundamental goal of fiscal policy is to implement expansive fiscal policy which would act counter-recessive on short term in order to give support to the economic activity, and in the same time to preserve macroeconomic stability and debt sustainability. This option was supported with the low debt/GDP ratio (24%) that enables the government more fiscal space for increased government spending, reducing taxes, stimulations in the construction sector, subsidies in the agriculture, external funds for detaining liquidate of real sector, administrative reforms for better business environment, long term investments in the infrastructure (roads, energy sector, and etc). All this measures that were undertaken by the government in the last two years gave stunning results in preventing serious decline in GDP and even surprising growth of 5, 3 % in the last quarter of 2011 beyond the projection of 3, 5 %.

In order to provide support for the real sector, which was most affected by the financial crises, at the end of November 2008, the government published the First fiscal package of ten measures in total value of 330 million euro. These measures were composed of the following stimulations and effects:

- ***Write-off of all unpaid interests based upon taxes and contributions for social security.*** (gain upon December 31, 2008), with condition of total pay-off of the debt principle. If it is paid until April, 31 (then will follow complete interest write-off, 100%), if it is paid until May 1 - August 31 (70% interest write-off) and from September 1 - December 31 (50% interest write-off).
- ***Write-off of all overdue obligations of the corporations upon contributions for obligatory health insurance.*** (these debts that gain upon December 31, 2008 are put on still in the following 4 years until December 31, 2012, and in that period the interest rate is not included. If the companies complete their current obligations in time, at the end the whole debt and the interest rate will be written-off).
- ***Reprogramming of tax obligations.*** For all the companies that have difficulties to survive, it's available payment off their own tax burden in installments.
- ***Transforming the demands upon public duties into permanent debt of enterprises as OHIS, EMO, EUROKOMPOZITI and TUTUNSKI KOMBINAT - PRILEP.*** The issue is about enterprises which have large accumulated lost for several years back and bad liquidity. In this manner, they will be able to confront their long-term liquidity problems and be prepared to become attractive for sale to some interested investors which will continue and expand their business activity. The goal of this measure is to attract foreign investor for the permanent solution of their problems.
- ***Regarding taxes – the profit in the future will be taxed only when it will be distributed as dividend, according to Estonian model.***
- ***Cutting back on unproductive expenditures of the Government, ministries, agencies, funds, public enterprises and other state owned companies.*** (like as, costs for celebrating new year, gifts, etc.)**.**
- ***For supporting the poorest farmers, the taxation is decreased for all that have annual income up to 1.300.000 den.*** In other words, the farmers with annual income smaller than 300.000 den will be exempted from taxation, while those above 300.000 till 1.300.000 den. Will have until 80% lower tax base.

- ***Reducing of rates for social contributions*** (on 4, 1 percentage points in 2009, for 3, 2 % in 2010 and 3, 7 % in 2011). With this measure, the costs for normal functioning of the enterprises and unemployment will be reduced and competition increased.

In order to improve the infrastructure and increase employment, the Government brought to light another, **Second package with anti-crises measures** in value of 8 billion euro. These measures were directed to increase the productive capital expenditures, which in 2009 were lifted to new level of 480 million euro. They are planed for roads, railways, energy infrastructure, schools, hospitals, sours, social apartments, sporting objects, etc. for the construction will be hired numerous Macedonian enterprises, which will provide work for many Macedonians and will engage other sectors. It is estimated that for realization of this Program, which will endure 8 years, on short-term will impact on the economic growth, mainly through the support of the construction sector, while on the long run this package of measures would improve the competitiveness of Macedonian economy.

Additional, on April, 2009 the Government step up with the Third package of 70 anti-crises measures intended for facilitating the consequences from the world economic crises on the Macedonian economy. In financial context, the package is worth 353 million euro, from which 173 million euro are budget expenditure cuts, and 180 million euro credit support for the enterprises. The package has 54 measures for facilitating export of goods and reducing the costs of the enterprises in the follow-up of regulatory guillotine, and 15 measures suggested from the chambers of commerce. Some of the most important measures are:

- **Decline in expenditures** for 10, 6 billion denars will secure top level of budget deficit from 2, 8 %, which is lower than many other countries in Europe. This level of budget deficit will provide macroeconomic stability, including exchange rate stability.
- The financing of the budget deficit will be full field through **foreign assets.** In other words, with importing 150-250 million euros from abroad, the total scope of assets will increase, as foreign currency. So, the banks potential will be more available for financing the enterprise needs for credit, instead for financing the budget deficit.
- The real sector will get **credit infusion** in amount of 180 million euro, from which 100 million are support from European Investment Bank (EIB), and the rest is expected to be mobilized from the domestic banks.
- The credit support will be directly forwarded towards **employment support**. The assets will be available for small and medium enterprises, which hire the largest number of workers. The basic condition for the enterprises will be to secure help for the workers to hold down for their jobs in these times of crises.
- The design of credit lines will solve the two biggest problems for the Macedonian companies: insufficiency of liquid assets and their price. Furthermore, 90 million euro (45 million euro from EIB and 45 million euro from domestic banks) will be used for short-term credits for working capital. In the same time, some of the assets will be used to **reprogram credits** in the same bank, which is very attractive.
- The additional 70 million euro will be used for long-term credits for investments (35 million euro from the EIB credit and the same amount from the domestic credit banks). The interest rate for both sorts of credit is subsided from the government. For the final user, it should be 6 % annually. The burden of such a low interest rate will be on the government in order not to disincentive the participation of commercial banks in the

programs. In other words, on the part which is co-financed by the government (50 % of every credit, and guarantee for that credit), the interest rate will be 1 %. That means that if the commercial bank chares 11 % on her cut (her 50 % from the credit); the total interest rate will not be higher than the default 6 % in the program. This means that the government has complete trust in the stability if the domestic currency. The government part in the credit (50 %) will be paid in denars, without currency clause. The duration of short-term (12 months) and log-term credits (5 years) clearly stipulates the government signal that there will be no change in the exchange rate.

- The credit support is meant for **increasing the export.** Thus, half from the projected credits may be used for support of export oriented enterprise activities. The package contains 54 more other measures focused on facilitating the conditions for export of goods.
- With the package of measures is anticipated that Macedonian bank for development and promotion will approve guarantees for executing contract liabilities, attendance of Macedonian enterprises on foreign markets, guarantees for good execution of services and other types of guarantees. The amount of assets for this purpose is 15 million euro.[3]

Besides these three packages of measures, the government continued in taking fiscal incentives through Fourth package of 24 fiscal measures in the area of tax policy, land policy, credit policy, property legal issues, agriculture, construction, social policy, measures in the regulatory guillotine.

Namely, according to Prime Minister Nikola Gruevski, the new anti-crisis measures:

- will modify the law of value added tax regarding the firms ability to pay obligations in respect of VAT on the 25th instead of 15th in the month, according to the legal change.
- will reduce the fee for the privatization of urban land by 30%.
- will prepare amendments to the Law on decentralization according to which the administrative procedure will end with a decision of second instance commission, and will improve the conditions for using the credit line from EIB and MBDP.
- Will prevent imports of products not manufactured by certain international standards accepted by Macedonia in order to protect the domestic producers and consumers from inappropriate competition and to facilitate the criteria for obtaining financial support.
- will be established fund of agricultural land intended to provide support for unemployed people living in rural areas and will shorten procedures and speed up more procedures in construction.

Extremely important to fiscal authorities is the awareness that the current crisis requires the deployment of the creative potential in the country, a wide process of consultation and openness to good ideas, to reach the best solutions. For this purpose, the government manages the process in ways that actively involves all chambers of commerce, businessmen, bankers and top economic experts, whose ideas are largely incorporated in the final decision of the government. Namely, according to economic experts and the positive results of the previous three packages of measures implemented by the government since the end of 2008 until 2010, contributed to improving the economic conditions, reduced the costs of the companies and facilitated the export

[3] www.mbdp.com.mk

and thus stimulated upward trend of economic growth towards the projected 2 % of the government and the IMF.

CONCLUSION

The final conclusion from this paper is that the government must at any cost find solutions and alternative routes for improving the macroeconomic conditions in any economy. This statement is supported by the recent actions taken by number of governments in order to initiate faster and stable economic growth. The measures that were taken vary from direct – discretionary fiscal policies to indirect – admistrative reforms, temporary facilitations, creating economic councils as independent monitoring of economic policies of the governments which would provide transparency in budget policies, coordination's of monetary and fiscal authorities, accepting suggestions from economic chambers, and etc. despite the measures, the paper pays a little, but essential review on the issue of debt sustainability and addresses crucial problem related to the way on which governments tend to perceive fiscal policy. Especially states the problem of consistent budget deficit policy in good times that proved to be pro-cyclical and inappropriate in times of crises, and reduces the fiscal space of government and put everything on stake for some political points. That's way this question is becoming more popular in terms of suggesting some fiscal rules that would be helpful in creating and implementing stable fiscal policy. Also, the question of faster economic growth gives enthusiasm to the governments to prolong their responsible and disciplinary fiscal policy, normally in coordination with monetary policy. This paper is also significant and from the aspect of fiscal policy measures undertaken in Macedonia which had proven as essential for private sector to surpass the decline in demand. The decline in domestic demand was substituted by the government demand for goods and services and government investments in different areas, which has proven to be effective in stimulating the economic activity in the country.

REFERENCES

Abel, E. B., Bernanke, B. S., Croushore, D. (2008). *Macroeconomics.* Pearson Education, Inc.

Atanasovski, Z. (2004). *Public finance.* Economic faculty. Skopje.

Blanchard O., Cottarelli C. (2010). Ten Commandments for fiscal adjustment in advanced economies. *IMF*

Eichengreen B., Feldman R., Liebman J., Von Hagen J. and Wyplosz C. (2011). *Public Debts: Nuts, Bolts and Worries.* Geneva Reports on the World Economy 13. International Center for Monetary and Banking Studies.

Gaber, S. (2011). *Budget deficit, Public debt an Economic implications.* Economic faculty. Skopje.

Langdana, K. F. (2009). *Macroeconomic Policy – Demystifying Monetary and Fiscal Policy.* Springer Science Business Media, LLC.

Mankiew, G. (2008). *Brief principles of Macroeconomics.* South-Western Cengage Learning, 5ed.

Spilimbergo A., Symanski S., Blanchard O. and Cottarelli C. (2008). Fiscal Policy for the Crises. *IMF*

Von Hagen, J and Wolff, G (2006), What Do Deficits Tell Us About Debt? Empirical Evidence on Creative Accounting with Fiscal Rules in the EU. *Journal of Banking and Finance* 30, pp 3259–79.

www.finance.gov.mk

www.mbpd.com.mk

www.vlada.mk