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Fiscal Policy as a tool of Economic Stabilization - the case of Albania

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Abstract. Processes such as globalization and integration, individuals' increasing reliance upon technology, limited vital resources in order to ensure normal life increase the complexity of our world and make the State's economic involvement compulsory. The theory of the use of fiscal policy for promoting economic stability is by now about forty years old. It may be time to ask to what extent fiscal policy has been used in practice as a tool for economic stabilization in Albania; how useful fiscal policy has proven to be, and finally what have been the main obstacles to fiscal policy as a means of economic stabilization. Currently Albania is facing enormous financial problems due to extremely low rates of employment, high levels of undeclared work, low financial discipline and a lack of equity and efficiency in tax matters.

In the case of Albania, fiscal policy helps to accelerate the rate of economic growth by raising the rate of investment in public as well as private sectors and the aim of this paper is to analyze various tools of fiscal policy, which should be used to do not affect the consumption, production and distribution of wealth.

Keywords: Fiscal policy, fiscal system, tax policy, economic growth, public sector.

Introduction

Twenty Years' Crisis, 1919-1939 has had a profound influence on both economic and political thinking. The consequences of this event turned out to be of such a dimension that broad consensus emerged on governments doing their best to prevent such disasters from happening again. But even beyond this extreme case, there is general agreement that a stable and predictable economic environment contributes substantially to social and economic welfare. In the short-run, households prefer to have economic stability with continuous employment and stable incomes, allowing them to maintain stable consumption over time. In the long-run, unnecessary economic fluctuations can reduce growth, for example by increasing the riskiness of investments. A highly volatile economic environment might also have a negative impact on the choice of education profiles and career paths. In short, by maintaining a stable macroeconomic environment, economic policy can thus contribute to economic growth and welfare.

Government economic policy, measures by which a government attempts to influence the economy. The national budget generally reflects the economic policy of a government, and it is partly through the budget that the government exercises its three principal methods of establishing control:

- a) the allocative function,
- b) the stabilization function, and
- c) the distributive function.

Over time, there have been considerable changes in emphasis on these different economic functions of the budget. In the 19th century, government finance was primarily concerned with the allocative function. The job of government was to raise revenue as cheaply and efficiently as possible to perform the limited tasks that it could do better than the private sector. As the 20th century began, the distribution function acquired increased significance. Social welfare benefits became important, and many countries introduced graduated tax systems. In the later interwar period, and more especially in the 1950s and '60s, stabilization was central, although equity was also a major concern in the design of tax systems.

Economic stabilization is one of the main remedies to effectively control or eliminate the periodic trade cycles which plague capitalist economy. Economic stabilization, it should be noted, is not merely confined to a single individual sector of an economy but embraces all its facts. In order to ensure economic stability, a number of economic measures have to be devised and implemented.

In modern times, a program of economic stabilization is usually directed towards the attainment of three objectives: (i) controlling or moderating cyclical fluctuations; (ii) encouraging and sustaining economic growth at full employment level; and (iii) maintaining the value of money through price stabilization. Thus, the goal of economic stability can be easily resolved into the twin objectives of sustained full employment and the achievement of a degree of price stability. The following instruments are used to attain the objectives of economic stabilization, particularly control of trade cycles, relative price stability and attainment of economic growth:

- (a) Monetary policy;
- (b) Fiscal policy; and
- (c) Direct controls

Today, foremost among the techniques of stabilization is fiscal policy. Fiscal policy as a tool of economic stability, however, has received its due importance under the influence of Keynesian economies only since the depression years of the 1930s.

Fiscal policy represents the use of government expenditures and taxes to influence the level of economic activity, is also the government counterpart to monetary policy. Like monetary policy, it can be used in an effort to close a recessionary or an inflationary gap.

The term "fiscal policy" is used not only for activities recorded on the revenue and expenditure sides of the public budgets, but also for investment expenditures by public enterprises and activities by the social security system. By the term 'stabilization policy' will be meant attempts by public authorities to keep the economy moving as smoothly as possible along a path close to 'full employment' , without an undesired rate of inflation and without balance of payments difficulties.

Broadly speaking, the taxation policy of the government relates to the programme of curbing private spending. The expenditure policy, on the other hand, deals with the channels by which government spending on new goods and services directly add to aggregate demand and indirectly income through the secondary spending which takes place on account of the multiplier effect.

Taxation, as a tool of fiscal policy, operates to reduce the level of private spending (on both consumption and investment) by reducing the disposable income and the resulting savings in the community. Hence, under the budgetary phenomenon, public expenditure and revenue can be combined in various ways to achieve the desired stimulating or deflationary effect on aggregate demand.

Thus, fiscal policy has quantitative as well as qualitative aspect changes in tax rates, the structure of taxation and its incidence influence the volume and direction of private spending in economy. Similarly, changes in government's expenditures and its structure of allocations will also have quantitative and redistributive effects on time, consumption and aggregate demand of the community.

As a matter of fact, all government spending is an inducement to increase the aggregate demand (both volume and components) and has an inflationary prejudice in the sense that it releases funds for the private economy which are then available for use in trade and business.

Similarly, a reduction in government spending has a deflationary bias and it reduces the aggregate demand (its volume and relative components in which the expenditure is curtailed). Thus, the composition of public expenditures and public revenue not only help to mould the economic structure of the country but also exert certain effects on the economy.

For maximum effectiveness, fiscal policy should be planned on both long-run and short-run basis. Long-run fiscal policy obviously is concerned with the long-run trends in government income and spending. Within the framework of such a long-range plan of fiscal operations, the budget can be made to vary cyclically in order to moderate the short-run economic fluctuations.

1.1 Importance and role of Fiscal Policy for Economic Stabilisation

Economies rise, economies fall, and governments try to keep them steady. The role of fiscal policy on economic growth has driven several studies both on the theoretical and empirical framework. Modern macroeconomic literature emphasizes both the short-run and the long-run objectives of FP [Romer, (2006)]. In the short run it can be used to counter output cyclicality and/or stabilize volatility in macro variables, which is descriptively same as the effects of the short run monetary policy. Further, for the long-run, FP and the debt financing methods can also affect both demand and supply side of the economy. The various tools of fiscal policy such as budget, taxation, public expenditure, public works and public debt can go a long way for maintaining full employment without inflationary and deflationary forces in underdeveloped economies. Obviously, taxation and public expenditure is a powerful instrument in the hands of public authority which greatly affect the changes in disposal income, consumption and investment. An anti-depression tax policy increases disposable income of the individual, promotes consumption and investment. This will ultimately result in increase in spending activities which in turn, increase effective demand of the people. On the contrary, during inflation, anti-inflationary policy measures help to plug the inflationary gap.

During inflation, such measures are adopted which help to wipe off the excessive purchasing power and consumer demand. Tax burden is raised in such a manner as it may not retard new investment. Keeping in view all facts in mind, it is stated that fiscal policy plays very significant role for promoting economic development and stability of under developed countries.

In general, if it can be implemented quickly and efficiently, fiscal policy (meaning changes in either spending or taxes) is a more effective means of dealing with such fluctuations, and with higher frequency fluctuations in GDP and employment more generally. To use fiscal policy to stabilize the economy however, a government has to spend more or tax less in the bad times (increase the deficit) and then do the hard thing which is to raise taxes or cut spending in the good times (decrease the deficit). To keep the budget in balance the good has to be matched somewhere by the bad.

If the government cut taxes for this disaster, or this recession, and don't raise them later, what will do next time? Cut again? It won't work forever. This is stabilization policy, not growth policy, and the goal is to keep the economy anchored as closely as possible to the target rate of output. If in each successive business cycle the tax rate is lowered, but it is never raised again, there will eventually come a time when the tax rate cannot be lowered any further. If a severe recession then hits, and monetary policy isn't providing the needed stimulus or interest rates are already so low that further decreases will be ineffective, then fiscal policy will be unavailable as

a backup stimulus device, much to our detriment. The priming of the economy during the bad times must be matched by a slowdown during the good. Borrow when income is low; pay it back when income is high.

Furthermore, in stabilization policy, it's also not possible in the long-run to use both government spending and taxation at opposite points in the business cycle. That is, suppose you cut taxes during the bad times, then cut spending during the good times to pay it back. That will work for a recession or two, a hurricane or two, but it won't work forever because eventually there will be nothing left to cut out of government. The opposite will not work forever either. If you increase spending during the bad times then increase taxes during the good, the size of government will grow indefinitely over the long-run.

In more graphic form:

$G \uparrow (\text{rec}) \rightarrow T \uparrow (\text{boom}) \rightarrow G \uparrow (\text{rec}) \rightarrow T \uparrow (\text{boom}) \rightarrow G \uparrow (\text{rec}) \rightarrow T \uparrow (\text{boom}) \rightarrow$ bloated government

$T \downarrow (\text{rec}) \rightarrow G \downarrow (\text{boom}) \rightarrow T \downarrow (\text{rec}) \rightarrow G \downarrow (\text{boom}) \rightarrow T \downarrow (\text{rec}) \rightarrow G \downarrow (\text{boom}) \rightarrow$ no government

These two policies or some combination of them (increase G and cut T in recessions, do the opposite in booms) are sustainable:

$G \uparrow (\text{rec}) \rightarrow G \downarrow (\text{boom}) \rightarrow G \uparrow (\text{rec}) \rightarrow G \downarrow (\text{boom}) \rightarrow G \uparrow (\text{rec}) \rightarrow G \downarrow (\text{boom}) \rightarrow$ sustainable size of government

$T \downarrow (\text{rec}) \rightarrow T \uparrow (\text{boom}) \rightarrow T \downarrow (\text{rec}) \rightarrow T \uparrow (\text{boom}) \rightarrow T \downarrow (\text{rec}) \rightarrow T \uparrow (\text{boom}) \rightarrow$ sustainable size of government

There are, of course, lots and lots of variations on these basic chains of events, e.g. to adjust the size of government the first or second strategies can be adopted temporarily, and hoping lawmakers would put all their cards on the table as they do so whichever direction government size is to be adjusted.

The point is that stabilization policy - changes in taxes or changes in government spending - does not necessarily change the size of government in any particular direction that is a policy choice. Traditionally stabilization policy maintains a constant budget balance in the long-run and whether to use tax changes or spending changes is a matter of effectiveness, not a matter of ideology about the size of government. Unfortunately, disputes over this issue can make it difficult to use fiscal policy as a stabilization tool. Even when both sides agree something needs to be done, different ideas about the size and functions of government can cause differences in the choice of tax changes or changes in spending as the means of stimulating or slowing the economy leading to policy gridlock.

In the political arena, gridlock can also occur when growth policy and stabilization policy are confused in order to block certain types of policies. For example, a tax increase during a robust economic expansion to pay off the tax cut enacted in the previous slowdown may be blocked by objections that it will slow economic growth. But that is the point of the policy in the short-run - the increase in the tax rate is supposed to stop the economy from overheating - just as the cut in taxes was intended to stimulate the economy on the other side. It's the average tax rate over the long-run that matters for growth (the stability of taxes also matters which is one of the reasons to prefer changes in government spending over changes in taxes as the stabilization tool). Politically, in the current environment, it is difficult to do anything to pay off the debt when the economy is expanding, increases in taxes or cuts in spending, because one of the primary objections is that it will slow growth. But if we are serious about stabilization policy we have to

somehow realize that the good times are the best choice for paying off the debts we accumulated when things weren't going so well.

It would perhaps be too simplistic to conclude that fiscal policy is the most important tool of financial correction and consolidation, especially that undertaken by the government. However, there is no reason to neglect this very powerful tool that is in the hands of governments and central banks the world over. Used properly, fiscal policy can determine the broad direction the economy of a given country is going to take.

Impact of Fiscal policy on economic stabilization - The case of Albania

During the last decade public finance was subject to major reformation aiming at government expenditure cuts and boosting revenues. The main objective of the economic policies during the medium term horizon is to preserve macroeconomic stability and continuing the structural reforms in order to create the necessary conditions for the Albanian economy to operate at its potential growth.

Besides, tax revenues witnessed major reductions in custom duties rate due to Free Trade Agreements under the Stabilization and Association agreement with the European Union, the CEFTA and World Trade Organization membership. This was followed by considerable raise in national, local and excise tax level, cuts in social contributions and small business tax and the changes in the threshold for Value Added Tax (VAT) registration. The government also aimed at achieving fiscal consolidation through budget deficit and public debt reduction through continuous fiscal consolidation. The philosophy of these fiscal reforms was based on the idea of reducing current expenditures (mainly personnel expenditure, subsidies and privatizing public owned companies), expanding the tax base, simplifying and implementing new tax system, promoting tax incentive through reducing tax burden on business, and reducing informality and tax evasion.

The fiscal systems represent a key factor to influence the efficiency of the economy. The subject on the effects of FP on economic growth is quite relevant, since the development of appropriate fiscal instruments could lead to a persistent and sustainable boost on economic stabilization. Thus, the aim of this paper is to examine the fiscal policy- economic stabilization relationship in the case of a small open developing country, Albania, as it is crucial to know how public activities through taxation and expenditure policies have served as tools of economic stabilization.

In this case the questions coming up relate to the analysis of which are the effects of fiscal policies on economic stabilization, in the case of Albania?

According to IMF estimates, the role of fiscal policy in Albania over the last decade has played an important role in macroeconomic stabilization, resulting in a low inflation rate and a stable public debt level. But in recent years and the IMF's optimistic estimates are falling, because in terms of public debt we are in a critical position.

Based on this fact, the Albanian government has taken some measures through programs studied by experts of the economy and approved by the IMF.

One of the actual government's current programs to achieve macroeconomic parameters that provide economic sustainability is the Economic and Fiscal Program 2014, which was based on the Budget Law for 2014, on the Macroeconomic and Fiscal Framework 2015 – 2017. This program was oriented in a trajectory of fiscal consolidation path. It aims firstly placing public finances on a sustainable trajectory, as one of the main pillars of economic growth and sustainable development of the country. For compilation of the fiscal policy in the medium term it has been consulted closely with the International Monetary Fund (IMF) and World Bank (WB). It is also fully in line with European Commission findings and recommendations

The main objective of the fiscal policy framework for the medium term ahead, was the level of structural deficit which ensures the sustainability of public debt over the medium and long term in one hand and minimizes the negative short-term effects on growth on the other hand. The main operational quantitative target of fiscal policy within the actual macro-fiscal framework is the overall fiscal deficit, respectively as following for each year:

- Overall fiscal deficit of 6.7% of GDP in 2014
- Overall fiscal deficit of 4.8% of GDP in 2015
- Overall fiscal deficit of 3.4% of GDP in 2016.

The public investments were projected to be kept at a level of at least 5 percent of GDP, which is an optimal level to support a sustainable economy for the coming years.

The set of measures in the Fiscal Package 2014 brought significant changes to the tax system, applied both on indirect and direct taxation. The net impact of these changes is estimated to be around 21 billion ALL revenues surplus in the Budget of 2014.

Value Added Tax: Pharmaceuticals and health services will be exempted from VAT, with effect from April 1st 2014, from the current reduced rate of 10%. In a broader framework of policies supporting the health sector, this change aims to reduce the cost to users of the health service system and pharmaceuticals.

Hydrocarbons: All exemptions from VAT on imports of goods for the stages of development, as well as domestic supplies to contractors and subcontractors related to the development stage of Hydrocarbons sites have been repealed. This has served as a fiscal incentive in favor of the research and development in the sector, until now. However, the exemption does not comply with the EU directive for hydrocarbons and has created over time abusive situations aiming to fiscal evasion and tax base erosion.

VAT Refund: Changes were made to the current procedures of re-payment of outstanding credit refundable VAT to taxpayers, from tax administration to the treasury, as well as the deadlines for control and approval of credit, to 60 days. This changes aim at: - Elimination of tax administration discretion in granting VAT refunds; - Ensuring the implementation of the main principle of re payment of VAT refundable "first in, first out"; - Reducing corruption cases to meet the requirements for reimbursement.

The consolidating nature of fiscal policy in 2015, expressed in the contraction of the budget deficit, has brought a low-impact public demand to economic growth. However, the reduction of public borrowing in the domestic financial markets has helped to improve the financing conditions and created space for a rapidly growing private sector. Fiscal policy has displayed a consolidating profile during 2015, in fulfillment of the government's commitment to reduce public debt in the medium term. Although fiscal consolidation implies a low impulse in economic activity in the short run, in the medium and long term it helps private sector development and strengthening of macroeconomic stability.

Despite the measures taken by government the current position of the public finances is an obstacle to achieve potential and stable economic growth in time. On one hand, the high level of public debt undermine the trust of economic agents for economic stability , and in the other hand the immediate need to engage in fiscal consolidation exerts pressure on short-term growth of the economy which is already extremely weak.

The need to consolidate public finances and at the same time fast payment of the accumulated arrears of the government to the private sector will be one of the priorities of the Albanian government during the second government mandate. The materialization of this priority will be assisted by a stabilization program with the International Monetary Fund.

Conclusion and Recommendations

After the theoretical and analytical treatment of fiscal policy in relation to the economic stability in our country we can conclude that Albania has made significant progress in recent years making the macroeconomic and economic stability in general not to be a difficult achievement despite the barriers that have occurred especially after 2008 but to provide its contribution to a steady and high economic growth.

From a longer-term perspective, the Albanian economy has shown signs of restructuring, shifting its manufacturing resources from the construction to the industrial sector. Likewise, within the service sector, we have shifted resources from low added value sectors, such as wholesale and retail, to higher value ones such as education and health. These structural movements hamper somehow economic growth in the short term. However, in the long term, they are necessary and should be strengthened further.

Albania FP has been under continuous scrutiny of major reformation on expenditure and tax collection system. The philosophy of these fiscal reforms was based on the idea of reducing current expenditures and boosting government revenues. The Albanian economy took advantages of macroeconomic stimulus in the form of fiscal expansion ahead of monetary adjustments, during the financial and global crisis. Raising budget deficit and public debt reflected both the action of automatic stabilizers in the form of reduced income and the countercyclical FP through wages and capital expenditure increases and also the cost of fiscal burden as a result of government decision to stimulate the economy, while fiscal incentives were narrowing.

The current data signal further slowdown in lending to the private sector, lower rates of income tax on economic activity and the decline of confidence in all sectors of the economy. Currently, the savings balance stands at a higher level compared to its historical average. Increased consumer savings could be interpreted as a sign of added care in the context of economic slowdown, increasing uncertainty about the future, and tight credit conditions.

Private investments are estimated to be affected by the financial and global economic crisis. Uncertainties about the economic situation in the country and abroad, the subdued level of domestic demand and external conditions and tight credit have resulted in the contraction of investments.

The message is loud and clear: Albanian government can use fiscal policy to smooth fluctuations in economic activity, and this can lead to higher medium-term growth. This essentially means that government needs to save in good times so that, can use the budget to stabilize output in bad times.

Of course, using the budget to stabilize output requires healthy public accounts that can take hard hits during severe storms. And when the sunshine returns, policymakers must be wise enough to repair public accounts in preparation for future storms. That's how stability, growth, and sustainability should go hand in hand.

The Albanian economy has been growing this past five years. The pace of economic growth accelerated, while the main indicators of economic and financial health generally had the improvement trend. Although growing, economic activity remains below its potential level. Aggregate demand is not sufficient to generate full utilization of production capacity, which is reflected in the still low inflation.

The acceleration in implementation of key structural reforms will also be a key lever to exploit the potential of the economy. In this regard, the aim is to improve the legal and regulatory framework of business operation and improve the overall business climate, to increase the competitiveness of domestic products and services, to further improve the financial sector, to reduce the informal economy, to complete the reforms of the public administration, starting the reforms on the pension system and going on with the reforms toward the labor market.

As a conclusion, the cyclical weakness of the Albanian economy requires pursuit of prudent incentive policies. Likewise, long-term problems require the continuation of structural reforms, to further accelerate economic growth and increase its sustainability.

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