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Comparative Fiscal Policies

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Synonyms

Comparative public finance; Comparative revenue policies; Comparative tax policy; Revenue collection policy; Tax policy

Definition

Fiscal policy is a macroeconomic tool employed by governments to promote growth and stability of public finances. Comparative studies analyze the variance that these policies present among countries and different levels of government.

Introduction

Economic theory is divided into two areas of study: microeconomics and macroeconomics. The latter studies global indicators, such as the aggregated production of final goods and services (commonly called the Gross Domestic Product, or GDP), income, expenditure, unemployment, interest rate, international trade balance, among other variables. The implementation of macroeconomics policies relies on two tools: monetary policy and fiscal policy (Friedman and Heller 1969; Shaw 1972). Typically, people have more awareness of fiscal policy, as it mainly operates through taxes and social spending, which are variables that directly affect household budgets. Moreover, within a country, fiscal policies can vary across central and local governments: the central government implements actions that affect the entire population, while local governments implement policies that primarily affect citizens in the region. Despite this, the objective remains the same, to promote the economic stability of the region and, consequently, of the government administration.

Currently, most of the countries and international organizations that advise them compare the fiscal policies adopted worldwide, in order to evaluate the effectiveness of implemented policies. Also, global differences are considered during the implementation of a policy framework, as each region has their own particularities in terms of government system and economic strength. Not comparing existing policies could increase the likelihood of policy failure and even prove counterproductive for the region. Therefore, comparative fiscal policy can lead to a better understanding of variables and actions that affect the economic performance of countries and different levels of governments.

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Main Features of Fiscal Policies

In terms of macroeconomic studies, fiscal policy is closely interrelated with monetary policy in aiming to affect economic performance. In an economy undergoing adverse circumstances, the government can increase available money by decreasing the interest rates or by buying its own bonds. The ultimate purpose of this strategy is to provide money to citizens to increase consumption, which commonly will reactivate the economy. On the other hand, if the government raises interest rates or issues bonds, it will result in excessive currency flows into the economy, making it more expensive to consume as people will have less money. This is a consequence of supply/demand laws–more available money decreases its cost, while less available money increases its cost.

The second alternative is to implement strategies affecting government income and spending. In contrast to monetary policy decisions, which are typically made by the central bank, fiscal policy decisions are the remit of executive and legislative (congress) branches of government. In this sense, when the economy is experiencing recession, with growth rates decreasing or stagnant, the government can reduce taxes. With this, both private sectors and citizens will have more available money to spend. Also, the government can increase its level of spending, by buying goods and services such as hospital equipment and providing lighting for public spaces. In this way, the government expenditure creates the need for more workers in sectors where public money is allocated, and more available money flows at both households and private sector levels, thus reactivating the economy.

On the other hand, the government can do the reverse when the economy is booming and there is a risk of inflationary behavior. Under this scenario an excess of money supply results in local currency losing its acquisitive power, thus people in the future have to pay more for exactly the same products. For example, a bus ticket costingUS$1 yesterday is now valued at US$1.5, because the dollar of yesterday is no longer enough to consume the same amount of goods today. In that case, the government will follow a countercyclical policy, raising tax rates or decreasing its spending level, leading to lower levels of circulating money.

Although the above seems straightforward, setting taxes and optimal spending is a difficult task. On the one hand, taxes must be progressive. For example, people may be taxed according to the level of wealth, thus people who are wealthy are required to pay higher tax rates based on the level of income. They should also be congruent (i.e., multinational producers of non-nutritious food pay higher rates than local producers of fruits and vegetables).Regarding social spending, resources must be distributed according to areas that generate the greatest social benefit, such as education (mandatory education and research and development), health care and childcare. Also, this type of spending must be channeled to address population needs which without government intervention would remain unmet.

The selection of fiscal policy mechanisms must consider the positive or negative consequences they entail. In the case of taxes, these consequences are called externalities. For example, concerns about climate change encourage some governments to tax individuals and companies that emit high levels of greenhouse gases. This tax generates a positive externality because it discourages the producers from polluting, and also the resources obtained can be used to alleviate pollution. Another example of positive externality concerns taxing sugary drinks. As these products become more expensive, the amount consumed decreases, allowing taxes to be reinvested to combat diseases such as diabetes. This approach related to positive externalities and taxes can also be applied to areas that generate benefits for citizens such as education, competitiveness, and innovation (Stiglitz and Rosengrand 2015). In these areas governments are prone to introduce tax deduction on tuition fees, and activities of research and development in order to encourage the development of human, technological, and economic potential.

Another positive aspect of fiscal policy is that benefits can be targeted to specific groups in society. In contrast to monetary policy, where results are applied to the economy as a whole, fiscal policy can be designed to benefit or affect only specific population groups. Taking the example of pollution, taxes for polluters are not transferred to those that behave in an environmentally friendly way. Concerning spending, the government can use mechanisms to shift resources to specific economic sectors. In situations of excess labor supply and limited demand (i.e., too many workers and too little construction), the government can build a new highway or rail line to provide employment for these workers.

Fiscal policy has the benefit of producing immediate effects, whereas monetary policy effects are typically seen in the medium or long run. For example, it is easier to establish a tax exemption that allows targeted companies to consume more immediately. In contrast, using monetary policy the government would have to decrease interest rates, allowing companies greater access to credit and new resources for consumption. However, as it has been said, the process of adjusting interest rates is not immediate, and the companies will have to wait until investors realize that it is more profitable to invest in the private sector. Also, the consequences of changes in the interest rates will affect the entire economy and not only target companies of a specific sector.

However, poorly devised and implemented fiscal policy could have negative consequences; even a well-intentioned fiscal policy can be harmful. In this sense, fiscal policies are typically linked to political agendas and potential tax increases might not be welcomed by citizens or private sector interests. Similarly, spending cuts may not be popular if they lead to workers losing their jobs, or citizens receiving fewer benefits (whether cuts in direct subsidies or reduced spending on social sectors).Therefore, fiscal policy might not be introduced because of political costs, with potentially effective long-term policy benefits being traded off against short-term political gains.

One final consequence of fiscal policy is that it may lead to a deficit, which means that the spending was higher than income for a given year. There are only two ways to finance a deficit: use your own savings or borrow money or borrow money from third parties. Nevertheless, a deficit is justified and acceptable if such savings or loans have been used to meet the demands of citizens or an infrastructure project that required an extraordinary amount of investment. However, some governments have used it as a tool for long periods. That implies that they will exhaust their savings or will have to keep borrowing resources indefinitely.

The above has two potential consequences for governments. Firstly, having no savings gives reduced capacity to face unforeseen contingencies. Secondly, it may lead to an unsustainable level of future debt, and so in order to pay the loan, government increase taxes disproportionately generating uncertainty for citizen and private sector budgets. Therefore, proper fiscal policies will reduce the likelihood of future deficits.

Comparative Fiscal Policies among Different Levels of Government

There are large differences between fiscal policies carried out by different levels of government. This is due to the type of taxes that each imposes, and the magnitude and specificity of spending. While central government establishes national taxes and expenditure policies, local governments (typically states and municipalities) may impose their own taxes and set expenditure whose effects apply only to residents.

Central government taxes are applicable to the entire population of the country and, in principle, have a uniform rate, regardless of the region where the taxpayer lives. This prevents arbitrage opportunities that would arise for citizens, whereby they could change their residence in order to pay a lower tax rate or avoid paying special and regional taxes. Although there are exceptional cases where lower tax rates apply to specific regions, this tends to be implemented with the sole aim of promoting the local economies, without encouraging tax evasion.

For example, income tax is normally set by the central government, although local governments in some countries also levy taxes on incomes. Income tax is levied on net income and capital gains of individuals. In most countries it is progressive, people pay greater tax rates according to their tax base which is defined according to their level of income, differing from a proportional tax which keeps the same rate despite the taxable base. In 2014, the average income tax for Organization for Economic Cooperation and Development (OECD) countries represented 8.42% of the GDP (OECD 2017). Other taxes commonly collected by central governments are related to consumption, most common being the Good and Services Tax (GST),also called Value-Added Tax (VAT), which tax the consumption of final goods, including food, medicine, and clothing. It also taxes the use of services, for example, hairdressing, dental care, and vehicle maintenance. The GST average for OECD countries was 10.97% of GDP (OECD 2017).

Moreover, local governments also impose taxes on consumption, although they are generally an extension or addition to central taxes. These taxes could be applied to goods and services consumed in specific regions, such as taxes applied to hotels or entertainment in tourist areas. Another example is tolls paid when vehicles enter urban areas. Finally, the vehicle tax is a common local tax, since there are regions where not only cars are taxed, but also motorcycles, tractors, boats, and yachts.

Property tax is also commonly imposed by local governments. If the central government decided to administer the property tax, it would have to know complete information about the characteristics of each property within the country. This is not only related to the size of any state, but to the commercial capabilities of the region. This represents great administrative work and cost for central governments. Therefore, local governments have comparative advantages in levying property taxes, as they have greater information regarding the characteristics of the land within their own territories. In 2014, the average property tax for the OECD countries was 1.86% of GDP (OECD 2017). However, it suggests a significant difference between the magnitude of the taxes levied by central and local governments.

In general, local governments are in close contact with people, so better understand their needs. As a result in federal systems, the fiscal policy of central government spending is geared primarily to sustaining the macroeconomic stability of the country, while local fiscal policy meets the demands of citizens. However, this is not always the case. Central governments may also seek to address population basic needs in terms of health, education, or housing, for example, by building the required infrastructure such as a new hospital or creating new programs of social assistance, as the local governments might lack resources to undertake large investments or program development. Also, similar to central government, local government can also incur deficit, which may allow the use of fiscal policy tools to ensure local economic stability.

Local governments have autonomy to define the allocation of its resources, although the degree of fiscal autonomy depends on the political structure of each country. The more autonomy local governments have, the less interference from the central government in making fiscal policy decisions. However, there is a potential problem of vertical fiscal imbalances. There are several countries where the collection of taxes is carried out by the central government, which reallocates those resources to local governments, through a system of specified rules. However, because of the autonomy of local governments, they are free to define the way resources are spent. On the other hand, there is an incentive problem, since the local government does not make an effort to collect taxes, but it spends them freely and irresponsibly on some occasions.

The World Bank (WB 2009) points out that the elimination of vertical fiscal imbalances is possible as long as the grant system has a clear objective, defining the specific use of resources and allocating them based on historical evidence. The grant system must also be fully transparent so that any local government has the same opportunity to compete for additional resources. Moreover, the system must be equitable, implementing equalization mechanisms to compensate for horizontal disparities in different regions. This ensures incentives align. First, it makes local governments aware of the significant efforts that must be devoted to collect taxes. Second, it encourages them to use the resources to obtain greater benefits in the future, and avoid having to generate additional income to offset the loss of profits.

Comparative Studies as a Technique for Fiscal Policy

Fiscal policy measures are not considered a single instrument applicable to all countries or regions. For this reason, a comparative approach presents opportunities to broaden the knowledge of measures and government activities that impact fiscal policy performance, or as some authors suggest, the study of a series of non-decisions that alter outcomes (Baumgartner et al. 2008). In this sense, comparative studies in social sciences make reference to techniques through which policies, politics, and societies across regions are analyzed by undertaking comparison. Recognizing the different alternatives that can be taken by the government to induce optimal economic performance, the comparative approach is a tool that evaluates the distinct alternatives undertaken by other governments at any level in an effort to introduce changes or retain a current policy. This can be undertaken in both the evaluation of fiscal policy as a whole or through assessing its components by specific area such as taxation or public debt.

Economists have found comparing economic policies a fundamental interest (Halm 1968), due to the feasibility of transferring knowledge to implementing new fiscal policies or reforming current ones. The transmission of elements, ideas, and general knowledge is aided by the access to international data and documents currently managed in diverse forums and international institutions. However, in the case of economic policies the approach from a comparative analysis standpoint recognizes that economic model must be tailored to local needs. Moreover, for fiscal policy, the geopolitical context is a key element when implementing policy and evaluating the outcomes, considering local decisions that alter outcomes (Shaw 1972). For example, the comparative approach has found that policies carried out in the European Union in terms of public deficit have differed in outcomes due to political values and ideology.

Beyond considering a unique economic model or a single framework, there are several fields within fiscal policy where comparative studies can be carried out. In a general way, it leads governments to assess the social costs associated with a certain fiscal policy adopted, i.e., by contrasting the welfare loss due to distortionary taxes, or allowing the assessment of the effectiveness of measures carried out within regions, such as fiscal system harmonization within the European Union.

Moreover, comparative fiscal policies can be used not only at the international level but within nations at the local level. This allows government to evaluate the impact of different variables on fiscal policy across local governments (such as potential tax collection) in a more systematic way (Baumgartner et al. 2008). In order to consider the comparative approach, governments and policy makers must have access to information provided by the government entities in charge of accountability, for example, local ministries of finance and audit offices.

Precise information plays a key role in implementing strategies regarding public finance. More often, international organizations have considered the inclusion of economic data sets. These are the source of information to assess the performance of the elements of a fiscal policy and predict outcomes of certain variables within a current or proposed framework for different countries (Debrun et al. 2013). Among the most robust databases used widely are those presented by the International Monetary Fund (IMF), OECD, and World Bank (WB). Nevertheless, federal authorities also produce public information regarding tax and expenditure. This is the case, for example, of the Mexican National Institute of Statistics and Geography (INEGI by its acronym in Spanish), which provides information that is used to make comparative fiscal policies at local levels (either state or municipal).

Comparative Fiscal Policy: The Perspective of International Governance

From 1944 onwards, preventing global economic uncertainty has been a shared focus. The institutions of Bretton Woods (IMF and WB) view stability as fostered through technical assistance to countries facing solvency problems (Woods 2007). The reason is that policies are not aligned with the needs of the economic system, and could threaten its stability instead of producing positive outcomes. Both institutions undertake intensive training through missions that allow governments to recognize advantages or disadvantages when dealing with economic issues. As policy makers or facilitators, these institutions gain understanding regarding the construction of specific national accounts in order to make the most precise data interpretation.

Nevertheless, the construction of a comparative fiscal policy has helped these institutions provide recommendations, leaving aside the concern that a fiscal policy can be applied homogeneously across countries, and that the unique alternative in the process of implementing a fiscal policy framework can be either expansive or restrictive. In a more explicit way, these institutions have used extensive comparative fiscal policy to consider further action in specific countries and local governments. The reasoning for applying a specific fiscal policy is made using robust datasets, geopolitical knowledge, and economic theory in tailoring fiscal measures. However, the introduction of alternatives in fiscal policy must be approved by local governments, recognizing that the common aim of any institution or government is to stabilize the Gross Domestic Product and ameliorate unemployment rates and fiscal imbalances.

Conclusion

As discussed through the article, increases and decreases in tax levels and spending areas are the main levers of fiscal policy. If fiscal policy is employed appropriately, it can generate important benefits. Fiscal policy allows governments to channel the objectives and benefits to specific sectors of the population, which means a direct impact of policy outcomes on population in the short term. Likewise, there are different types of taxes and social spending according to the level of government. In federal systems, central governments seek macroeconomic stability, while local governments seek the welfare of the population, although roles might be modified in certain circumstances and differ from alternative types of governments such as a unitary parliamentary system. However, if fiscal policy is not well designed, there may be vertical fiscal imbalances. Therefore, a well-designed, transparent, equalizing, and inclusive grant system is required to ensure the alignment of incentives among distinct levels of government.

Moreover, comparative techniques in fiscal policy are used to create recommendations by international institutions and research institutes. By assessing the introduction of these innovations or reforms, governments can receive advice about the impact of changes to occur within the territory. However, given the complexity of economic policy, comparative intelligence does not lead to the same results among governments. Fiscal policy remains politically and electorally sensitive because government income, spending, and debt have direct impacts on the population. More widely, fiscal policy may lead to policy scenarios that might damage the macroeconomic performance of a country.

Cross-References

► Economy Policy
► Fiscal and Tax Policies
► Public Policy and Public Finance
► Tax Policy

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