

Optimal Fiscal Policy – Factors for the Formation of the Optimal Economic and Social Models

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ABSTRACT

Objective – The purpose of this paper is to develop the optimal economic and social model for the modern stage and analyze the Social Progress Index in Georgia. The research is based on the paradigm that “what we analyze, this determines the decisions we make”. Consequently, emphasis is placed on issues that significantly affect human well-being.

Methodology/Technique – In this top-down study, the empirical material is collected from official documents and public statements made by centrally placed politicians and administrators in Georgia as well as research conducted by international organizations in Georgia. The research database used is the legislative and normative acts adopted by the government of Georgia in the modern day, in particular: the National Statistics Office of Georgia, the Economic Development and Finance Ministries, the Georgian National Statistics Office, the Parliamentary Finance and Budget Committee and other related departments.

Findings – This study shows that the formation of the optimal economic and social organization model of a country is particularly dependent on the selection and implementation of the most appropriate fiscal policy. The philosophy of social security is one of the greatest achievements of modern civilization. The present work is dedicated to the progress of human development – specifically, welfare issues. This provides the model for creating the optimal social security system of a population, with the following social system parameters: distribution of national income to the population and their families and addressing the issues of financing social security needs. Based on the study of the social experiences of social reform and the social indicators of the European Union, the alternate concept of prosperity and perfection is developed. These topics are the focus of the present work.

Novelty – The empirical material contained within focuses on the period after 2005, when some important changes in political leadership took place. In 2003, Saakashvili became President of Georgia, Ivanishvili was elected as Prime Minister in 2012 and Kvirikashvili took over this position in 2015. During this time, there was also a shift in government social policy at a central level. The collection of empirical data for this study ends in 2017, giving a total study period of 12 years.

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1. Introduction

One of the main objectives of fiscal policy is to promote an increase in economic activity, production volume and standard of life for a population. Any kind of budget system will undoubtedly aim to support economic effectiveness, political stability and social justice. If this is not achieved, this may result in an increase in inflation, growth of unemployment, a deficit of qualified personnel, and an overall deepening of inter-budgetary issues (Abuselidze, 2015 a).

Further, another primary objective of any progressive state is the creation of machinery and other tools that can be used to promote and increase the welfare and social protection of the population, which stimulates economic activity. The present research establishes the connection between economic growth and social indicators. However, the economical variables do not represent a complete picture of social progress; it would be correct to conclude that social progress is indeed a prerequisite for economic progress.

Due to the increase in fiscal policy issues, there has been considerable debate surrounding the efficacy of current policies. Hence, it is important to investigate and understand what it is that people really want to achieve with such policy, to improve quality of life quality, development and sustainability. One of the primary objectives of all mankind is to achieve ones' greatest potential; it is accepted that this task is made easier through support of satisfactory fiscal policy.

It is important to note that, factors such as GDP, structure and level of income, expenses on material consumption and service consumption, labor markets, social guarantees, social progress all have an effect on social progress.

2. Theoretical Basics

Classic economic schools link a country's wellbeing to its GDP. According to these theories, social progress is a direct result of economic growth. Traditionally, social activities have been associated only with expense and cost. However, in modern European countries, social policy is implemented in three ways (Gelitashvili, 2011). These were outlined in the 1990s by Andersen (Esping-Andersen, 1990):

1. The Continental-European or Conservative Model;
2. The Scandinavian or Social-Democratic Model;
3. The Liberal or Anglo-Saxon Model.

2.1. Social-Democratic or Scandinavian Model

V. Khanesh (Gelitashvili, 2011) defines the social-democratic model as Nordic (Denmark, Finland), according to which all citizens are entitled to social security, financed by equal taxes and the employed portion of the population is paid additional benefits. As a result, only unemployment insurance is separated from the state social welfare system. This is based on the principle of voluntariness and is primarily financed by state taxes. Eligibility for social welfare requires that a person must belong to a certain category or group which is provided with the standard monetary or natural assistance (food) and that offers of certain list of services.

2.2. Continental-European or Conservative Model

According to Khanesh, the model for the development of an aid system by social insurance is differentiated according to the types of labor activities in the country (Germany, Austria, France, Benelux countries). Social security is directly or indirectly distributed to the working population (for family

members). Conservative social security is a criterion for social assistance – i.e. fulfillment of obligations. It uses the classical Bismarck system of social insurance. The primary objective of this model is to maintain the status quo of employment. This system has been tested in many Western European countries, particularly German-oriented countries.

2.3. Liberal or Anglo-Saxon Model

The Liberal Model, which implies that the state use the minimum amount necessary to support the population. Khan is known as an Anglo-Saxon (Britain, Ireland). It covers a very low level of social insurance and social assistance with a decisive role. However, while the UK health system implements free medical care of the entire population, the use of state medical services in Ireland can only benefit from low salaries. According to the liberal model, the social assistance criteria is characterized by the state's desire to divide social support from the free market to provide it targeted assistance. The main objective of this system is the elimination of poverty.

Further, the liberal, or Anglo-American model, is based on the principle of fair justice, with a focus on national solidarity. Funding of such systems of social security is carried out at the expense of insurance contributions, as well as tax deductions. Allowances and health care provided to families is financed from the state budget and other social benefits. In contrast to the Bismarck model, this model provides very low insurance premiums and social assistance plays a dominant role. This model is also characterized by the widely used practice of revenue inspection practices, which are used to generate the benefits that are then distributed to those in need.

2.4. Corporative Characteristic of Social Models

In contrast to the conservative model, in countries with Anglo-American or liberal social protection models, there are no organizations responsible for managing social risks such as aging, sickness, unemployment and so on. This model places great importance on the principle of individualism and the interests of individual groups of the population. The main feature of the social security system in the liberal model is that it does not include the existence of separate insurance contributions for certain programs (retirement, medical insurance, disability pensions, etc.). Hence, all of the expenditures for financing these programs are covered by a single social tax. Khanesh also describes one additional model: the rudimentary model, which is prominent in southern European countries. Social protection of citizens is carried out in many cases through family or private charity. Any model of social policy can not be without financial security.

3. Survey

The main function of any fiscal policy is to ensure the socio-economic welfare of society. The level of well-being of the country depends on how well its economic system is developed and what kinds of security guarantees are created. Well-being is determined by the material benefits and services necessary for a comfortable and safe life. “The material progress of the nation, its well-being, is only achieved if it leads to moral and material well-being of every citizen” (Jibuti, Kakulia, Bakhtadze, 2009).

Social issues are given great priority when compared to economics in both developed and developing countries. The Social Progress Index aims to raise awareness and influence political decisions and institutions around the world on social issues and is used to measure a country's well-being status. The Index addresses the following factors: 1. Basics of Welfare, 2. Human Basic Needs and Opportunities.

A person must have a guaranteed right to life, including access to food, medical care, and social security for unemployment, illness, disability, old age and others. If the realization of the goals of fiscal policy affects the accumulation of material capital, then the realization of the goals of social policy affects human and

social capital. All civilized states have adopted laws about minimum living conditions, the main characteristic of which is the compliance with minimum living conditions and minimum wages.

The most important international indicator of welfare is the Index of Economic Activity Potential Development, which is calculated on the basis of the standard of living, which expresses the volume of real GDP per capita. In 2016 the total domestic product in Georgia was at 34,028.50 million GEL, which represents a 7.2% increase on the previous year. Further, Georgia's GDP grew 2.8% compared with the previous year. In this regard, the GDP in Georgia is lower than in Turkey (5.1%) and exceeds Armenia (3.5%), Russia (1.8%), Ukraine (2.0%) and Belarus (0.7%) [16].

However, despite consistent economic growth, there has been no significant reduction in poverty levels. It is well known that socioeconomic development within a country is improved by strengthening the financial health of the country, what may be achieved by implementing optimal tax policies; this is often easier said than done.

Foreign research in this area has concluded that time is an important consideration to how the average total tax rate changes. This is demonstrated by the following formula:

$$\lim X_n = +\infty \text{ and } \lim Y_n = +\infty, \quad (1)$$

$$\text{where } y_{n+1} \succ y_n, \quad x_{n+1} \succ x_n$$

Hence, taxes are differentiated by awarding privilege to public welfare by tax-payers, however, such differentiation does not conflict with calculations of tax burdens using the below formula (2). That function may be expressed with the following formula:

$$\begin{aligned} \int a_{11}x_1 + a_{21}x_2 + \dots + a_{1n}x_n &= b_1 \\ \int a_{21}x_1 + a_{22}x_2 + \dots + a_{2n}x_n &= b_2 \\ \int a_{n1}x_1 + a_{n2}x_2 + \dots + a_{nn}x_n &= b_n \end{aligned} \quad (2)$$

$$\text{where } b_1=b_2=b_n=38.2\%$$

Our assumption that tax policy optimization is inconsistent with the view of Sandmo (1990), who considers that tax indicators are indeed fixed. The present study considers that tax policy shall be formed in such a manner that facilitates progression of tax rates and determination of tax burdens generally, with progression towards businesses, which is differentiated between large-scale, medium and small-scale companies.

Although many countries have reformed their tax systems over time, many of them still fail to meet the requirements of economic development. This refers to total tax burden, its distribution and formation of the appropriate mentality in the market economy. Hence, when a state fixes its tax burden, or changes its tax rate, it should determine who will bear this tax, depending on the socioeconomic state of the country first. It may be useful to use the calculation of the population employment efficiency coefficient for analysis of socioeconomic status of a state for this purpose. This analysis uses the following formula:

$$Kde = 1 - \sum_j^i \frac{Pe + Pu}{Pea}, \quad (3)$$

Where:

K_{de} - population employment efficiency coefficient;

i, j – quantity of population groups according to employment;

P_e – quantity of population employed at a disadvantage;

P_u – percentage of unemployed population; and

P_{ea} – economically active population.

Unfortunately, most authors in this area fail to pay attention to the impact that different tax treatments and rates have on macroeconomic balance and employment rates. This study disagrees with the theory postulated by Laffer-Keynes which states that the imposition of the optimal average tax rate itself cannot increase employment rates, or initiate a transition to maximum mobilization of tax proceeds within state budget (Abuselidze 2015 b, pp.603-605).

Optimal tax burden is achievable when a favorable economic environment is achieved. Such circumstances is achieved by simultaneous growth of revenues and output. It is proposed that an optimal tax burden is 38.2% (see Figure 1) (Abuselidze 2012, pp. 121-130).

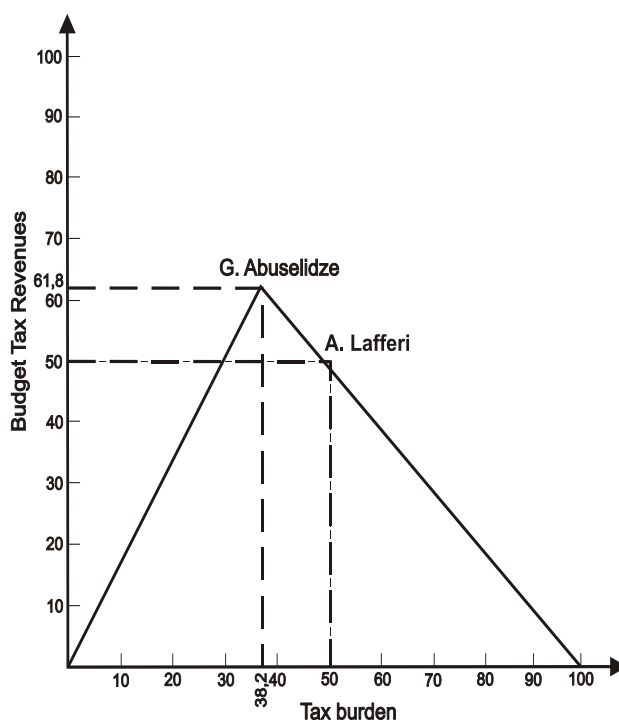


Figure 1

Fiscal policy is able to increase economic prosperity by increasing economic activity and the volume of production in a country, resulting in a reduction of unemployment, improved labor and living conditions, as well as the formation of a basic social security system and developing human capital.

At the same time, governments should take responsibility to assist and target social assistance to the poorer populations. Funding of social programs and social policy is directly dependent on GDP. In this regard, it is interesting to note that social progress in different countries refers to GDP per capita (see Figure 2).

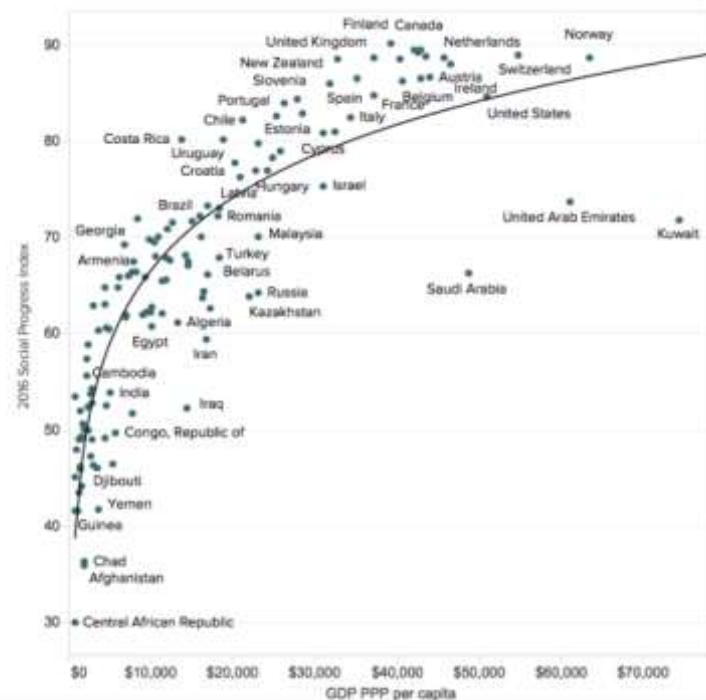


Figure 2. Social Progress Index vs GDP Per Capita

According to the results of the survey above, there is a significant difference in the social progress rate among developed and developing countries. The figure above demonstrates the relationship between GDP per capita and overall social progress; a relationship that has not previously been examined. The data reveals several key findings. Firstly, there is a positive and strong relationship between the Social Progress Index and GDP per capita. On average, countries with a higher income tend to have higher social progress: for example, Finland (\$38,535 GDP per capita) is ranked highest for social progress while the Central African Republic (\$567 GDP per capita) is ranked as the lowest. At the aggregate level of the Social Progress Index, and without controlling for additional factors, a 1% increase in GDP per capita is associated with a 0.11 point increase in the Social Progress Index score. However, countries such as Kuwait, United Arab Emirates, and Saudi Arabia all have high GDP per capita, but relatively low social progress, and vice versa.

Secondly, the relationship between economic development and social progress is not linear. At lower income levels, small differences in GDP per capita are associated with large improvements in social progress. For example, according to World Bank data, the income of the population in Georgia in 2013 was \$8,040 dollars, while in Armenia it was \$8,140 dollars, in Azerbaijan - \$18,180, in Russia - \$23,200 and in Turkey – \$18,760 dollars. This means that incomes of neighboring countries and their purchasing power is greater than that in Georgia.

The welfare of the population depends not only on revenue but also exchange rates. According to World Bank data, the total income in Georgia in 2016 was \$7,400, according to the proportion of the GDP per capita. According to this indicator, Georgia is ranked 139th in the world meaning it is greatly exposed to countries such as Armenia, Turkmenistan, Belarus and Azerbaijan. In 2009, Georgia's GDP per capita was \$5,440 per parity with a per capita purchasing cap of \$5,730 in 2010, \$6,140 in 2011, \$6,760 in 2012 and \$7,040 in 2013.

This means that the welfare of the population in neighboring countries is higher than in Georgia. However, a comparison of the index of social progress and GDP by a country asserts that economic development is necessary, but the lack of social conditions for social welfare, and in most cases economic growth, is caused by social progress. Based on this, it is necessary to reflect on the effective implementation of social security systems contained in the EU-Georgia Neighborhood Policy Action Plan. This relates to factors such as adequate pensions and unemployment and health insurance systems. The EU can provide substantial assistance to the government of Georgia in this area as the laws developed by the Ministry of Labor, Health and Social Protection, as they currently are, have some serious shortfalls. This includes those policies relating to social assistance, determination of social packages, monetization of social benefits and the award of living allowances, according to which populations below poverty line are registered in the single base with awarding of identification points, which determines the size of living allowance they receive. This system is as follows:

- a. up to 30 000 points – 60 Lari (for each family member).
- b. 30 001 to 57 000 points – 50 Lari (for each family member).
- c. 57 001 – 60 000 points – 40 Lari (for each family member).
- d. 60 001 – 65 000 points – 30 Lari (for each family member).

One of the main shortfalls of this policy is in the wording of the registration of socioeconomic conditions of a family, although the assessment provided by social agents has no effect on the rating points allocated to each family. For example, possession of housekeeping objects (cooker, TV set, iron etc.) do not affect rating points, however public services expenses and ownership of land (agricultural and/or non-agricultural) upon which cultivation may be impossible due to lack of capacity or means, is taken into consideration when allocating rating points.

In 2016, 67.5% of the working population (15 years and older) were part of the economically active population. Economic activity had therefore decreased by 0.3%, while employment levels remained at 0.2%. Compared to the previous year, employment levels in city-type settlements decreased by 0.5% and 0.1% in rural areas. Further, the level of activity in city-type settlements decreased by 0.8% and 0.1% in rural areas (see Figure 3) compared to the previous year.

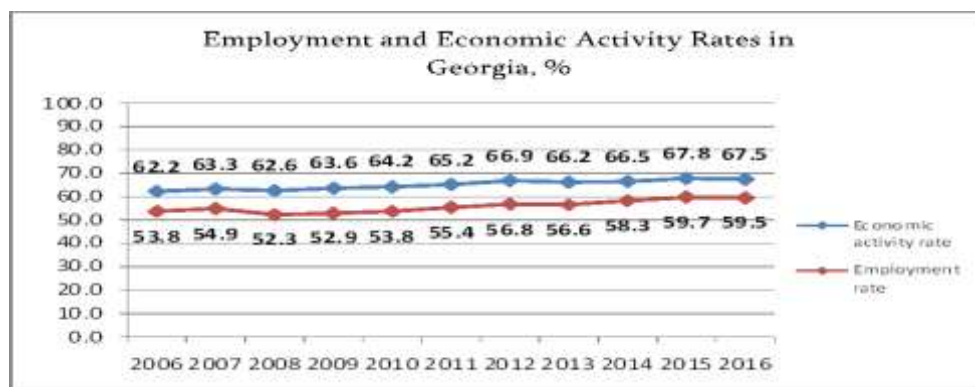


Figure 3.

Source: National Statistics Office of Georgia

In 2016, unemployment rates in Georgia decreased by 1.8% compared to the same in 2006. It should be noted that in 2016, the unemployment rates in Georgia were at the lowest level for the last 13 years. In addition, unemployment rates are much lower in rural populations than in the city. In 2016, unemployment rates in urban settlements decreased by 0.4% and in rural areas, it had increased by 0.2% [18]. This highlights another shortfall in the socio-economic reforms in Georgia, in that they do not have a clear social policy that enables the state to adequately control social processes. A reduction of unemployment rates can be achieved through the improvement of business environments and economic development, however a efficient fiscal policy is also imperative to the promotion of employment and for the creation of new jobs.

In the present period, improvement of Georgia's social security system is considered with regard to 2 aspects: the implementation of employment and optimal tax policies to increase the standard of life for employed people and their families and the promotion of insurance mechanisms to stimulate conditions of realization of social risks with financial security and retirement savings.

Within the economic reforms recently implemented in Georgia, particular emphasis is placed on macroeconomic stabilization, as well as strengthening of the state's financial position, through the use of well-reasoned budgets and tax policies.

Based on the assessment of pension and social assistance systems, according to the state budget for 2017 (published by the Ministry of Finance), it appears that the social protection system in Georgia does not sufficiently meet the requirements of the system itself; it does not provide real assistance to the socially unprotected segment of society (it does provide a living wage), it is not economically and socially effective, it does not promote the eradication of poverty nor does it provide social stability.

Georgia is a particularly unique country due to the variety of natural-climatic conditions within its regions, which is enviable even to countries with large territories; these factors effect the development of various sectors of its economy, including its regional economies. In such conditions the government may assist with domestic finances to balance both economic and social development, which has often lead to a reverse of the economic and social conditions in comparison with the other regions, due to certain historical and natural conditions.

Transformation of the income distribution model in Georgia is evidently necessary, although the Nordic model is the best model for the distribution of income. This study considers that such a model may be operated only in high-organized societies however this does not mean that the states using the liberal model (such as the USA and the United Kingdom) have no control over their socioeconomic processes. This simply means that, due to the approach taken by their respective governments, they prefer to manipulate market processes and increase the role of society, which implies the availability of powerful institutions in the non-governmental sector. For this purpose, the state will facilitate the conditions for this, such as harmonious legislation and promotional circumstances.

Fiscal policy alone has the greatest role to play in the provision of financial assistance to the population of a country. Modern socioeconomic conditions motivate states to provide varied and tailored social services. For example, Holland and the Scandinavian countries maintain the active process of decentralization and assignment of responsibility to municipalities, whilst some EC countries (17) have introduced a new model known as "welfare pluralism" [14, p.4].

In the present conditions, it would not be adequate to focus on any one model in isolation. However, the conservative model may be of assistance. It originates from the theories of Otto von Bismarck's and its introduction in Germany proved to be quite effective. The Bismarck's model is based on social insurance which can be used for determination of wages, pension age, the size of pensions sufficient to meet social standards, the quality of allowances and medical assistance. The social security system in Germany operates as per the principles of self-regulation; social insurance institutions are given full legal, financial and organizational independence from governmental institutions, although the legal rules of their formation and the function of insurance institutions remain regulated by the government.

Evidently, most countries are concerned with the efficacy of their social policy. It should be noted that, the Georgian government is not able transfer responsibility for social policy to any other body. Therefore, while the government remains responsible for the provision of pension for existing pensioners, which will not likely have the benefit of any state pension funds which may be put in place, the establishment of those funds is also not a viable option, for future generations of retirees.

Retirement insurance is considered the most important part of social security in Germany. According to the applied principles, each person is not entitled to be paid more than one kind of pension. In that sense, the pension system is responsible not only for ensuring the workability of insured persons, but their improvement and restoration.

The researchers therefore conclude that it is prudent for the state of Georgia to examine the social security system of Germany which relies on the principle of insurance which means that the population will be paid the old age pension from their own accumulated funds; social assistance that is not based on earlier contributions; and insurance that is financed from the tax revenue of the state budget. The most important of these principles is the principle of allowances. This principle relies on financing from the state budget, similar to the funding of social security.

4. Results

Qualitative and quantitative analysis of the present economic situation in Georgia shows that the face of socioeconomic crisis is multi-sided and large-scale. The absence of a single strategy for managing this situation necessarily makes the situation worse. It is concluded in this paper that the only way to achieve harmonization of sectoral and territorial principles is efficient management of the economy and support of the optimal economic and social development of the country. One of the most important drivers of this is the formation of an optimal fiscal policy (G. Abuselidze (Abuselidze, 2012 a)).

Maintenance of economic productivity and a rapid increase in production volume are the central issues in the current economic climate. These factors largely depend on the fiscal and social policies of a country. It is also clear that the current critical economic situation in Georgia has caused a division of the society into 2 conditional parts: one requires that the government use maximum effort to provide small levels of social support, while the second demands a reduction of the tax burden and increased support for small businesses.

It is clear that the present social security system fails to satisfactorily address the social security needs of the population of Georgia (Abuselidze, 2012 b). The system therefore requires reform relying on the new approaches and providing formation of the adequate institutions.

The most efficient means of eradicating poverty is improving accessibility to economic activity and regular income. Social policy should be closely related to employment policy and aim to promote and achieve employment for all citizens.

5. Conclusion

Georgia should focus on achieving an acceleration of economic activity and growth of production volume in such a way that provides appropriation of its sectorial development structure, in the interest of those populations living with low income and below average living standards.

The state of Georgia should consider reforms to the structure of their budget, the allocation of the necessities of the population, in particular the social service sphere. In addition, it is important that socioeconomic progress is supported by the private sector, and a growth in private investments should undoubtedly promote a decrease in poverty rates.

With respect to the distribution of income and the reduction of poverty, institutional changes should aim to promote a stronger civil society. One of the most important factors for reducing levels of inequality in incomes and poverty is the formation and development of competitive markets. It is also important to expand the financial market and develop an adequate credit policy.

The successful maintenance of the above arrangements will promote an increase in the standard of living and employment rates, which is important for the development of any country.

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