

Creation of Innovative Approach for Study of the National Fiscal Space

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Abstract. The choice and topicality of the theme is substantiated by the fact that a sustainable development of a country is affected by the policy implemented by the government. One of its main parts is the fiscal or budget policy which means the formation of the necessary funds of the revenues and expenditures to ensure the functioning of the government. Accordingly, the concept of fiscal space has been activated which is closely connected with the implementation of the instruments of fiscal policy (taxes, government expenditures, government debt). The aim of the research is to create an innovative approach to the investigation of the creation of the state fiscal space applying the simulation method in the environment of Matlab/Simulink in order to forecast the influence of the corporate income tax on the state economic and financial indicators taking into account the changes of the corporate income tax offered by the government and the Bank of Latvia. Methodology of the research implies the following activities: the identification of the concept of fiscal space and its application in the context of the influence on economy; the creation of the assessment methodology of the components of fiscal space using technological tools (data modelling in Matlab / Simulink environment).

Keywords: economic development, fiscal policy, fiscal risk, fiscal space, taxes.

I. INTRODUCTION

The choice and topicality of the theme are substantiated by the fact that the sustainable development of any country is influenced by the government policy. One of its main constituent parts is the fiscal or budget policy. Traditionally, it is defined as the policy to form revenues and expenditures in order to ensure the activities of the government. But in the economic interpretation it means the regulatory system of economy by means of taxes and government expenditures. It should be noted that it is closely connected with the role of the government to redistribute the income of the society stating the proportion of the state budget in the gross domestic product defining the objectives for the common tax burden, expenditures of the budget, the permissible deficit, the amount and structure of the debt of the government.

For the necessity to apply the instruments of the fiscal policy it is important to understand the cyclical development of economy – economic growth, the level of high demand, supply and the general level of the well-being of inhabitants interchanging with the periods when the growth rate declines as well as the income of employees which negatively influences the total demand for goods and services. This combination of circumstances can cause economic crises, the overcome of them can be long-lasting and hard for the society as a whole. In such situations the government can purposefully intervene in the economic processes in order to restore the economic stability in a short-term period and to ensure a sustainable development in a long-term period.

The development of the financial and economic theory and practice in the world has already for a long time laid emphasis on the role of fiscal measures taken by the governments in the regulation of counter-cyclical economy although sometimes it means the adoption of unpopular decisions (the reduction of budget expenditures, the increase of taxes) [9].

At present the concept of fiscal space is topical in the financial policy-making in Latvia which is closely connected with the application of the instruments of fiscal policy (taxes, government expenditures, government debt). There are discussions about the size and preconditions of the formation of fiscal space. The government has also proposed an extensive tax reform pointing out that in such a way the economic development will be promoted and the state fiscal situation will improve. Along with the reform it is proposed to change the method of collection of the corporate income tax.

On the basis of the above mentioned explanation the authors of the research have evaluated a definite situation in Latvia analyzing the relevant trends in the area of the corporate income tax according to the legislation and the tax reform proposed by the Bank of Latvia.

The aim of the research is to investigate the formation of the state fiscal space in the context of a particular tax, i.e. the influence of the corporate income tax on the state economic and financial indicators applying the simulation methods in the environment of Matlab/Simulink and to show Matlab/

Simulink suitability for the purpose of visualizing simulation models of various economic situations.

In the research the authors have used the monographic method, logical constructive method, the method of analysis, the comparative method of opinions and conceptions as well as the method of the simulation and modelling of the situation.

II. EVALUATION OF THE CONCEPT OF FISCAL SPACE

In the literature on economics and in the financial practice in the countries the conception "state fiscal space" has only recently been topical in connection with the beginning of the economic crisis in the USA in 2007 and later on also in the European countries [13]. The crisis reached Latvia, too, which negatively influenced the process of the formation of the state budget increasing the state budget deficit and the government debt. As we know, in the period of 2009 until 2011 there was a very painful consolidation process of budget in Latvia.

According to the definition the fiscal space is the ability of the government to be flexible (flexibility) making a choice or, expressing it figuratively, it is the financial well-being of the government. The Deputy Director of the International Monetary Fund Peter Heller defines this concept as "room in a government's budget that allows it to provide resources for a desired purpose without jeopardizing the sustainability of its financial position or the stability of the economy". So, the concept "fiscal space" has a broad sense but, simply speaking, it means free or "released" funds which can be redirected to certain activities. Traditionally, the concept "fiscal space" is defined as additional resources for financing new state expenditures to ensure the development processes of economy [15].

At present the concept "state fiscal space" is applied in the context of the evaluation of the implemented fiscal policy in the country. At the same time there are different opinions in the economic literature how to define and calculate the fiscal space in the country:

- calculating the debt level of the government [16];
- taking into account different measures of tax receipts, that is, the structural changes of the tax policy [8], [11].

On the basis of the opinions about the investigation of the fiscal space we can emphasize the following aspects:

- sustainability – creating the resources at government's disposal with the aim to provide a sustainable state financial policy [15];
- development – mobilization of government's funds ensuring a favorable institutional and economic environment for certain political activities in connection with particular measures stated by the government [14];

- budgeting – the allocation of funds for specific political initiatives stated by the government in the year or medium term budget expenditure framework [14].

So, a clear understanding is needed about the influencing factors and preconditions of the fiscal policy-making of a country in the context of the consistency of the adopted decisions in connection with sustainable development (social, economic factor). Thereby, it is important to evaluate the financial influence of the state on the state socio economic development when activating such concepts as "fiscal capacity" and "fiscal incentives".

The authors can make a conclusion that at present the fiscal policy has been positioned to the understanding of fiscal space and fiscal capacity. There is an opinion that the concept "fiscal space" is rather vague which means that there can arise different interpretations. But we can generally say that the fiscal incentives are connected with the possibility to decrease the debt of the government [16]. It all determines the need for an effective financial management in the country.

III. THE PRACTICE OF CREATING FISCAL SPACE IN LATVIA

Since joining the Eurozone in 2014 the financial management and supervision of the state has substantially improved in Latvia. According to the Law on Fiscal discipline the system of the fiscal risk management has been introduced in the country which has already been functioning for three years. It includes the identification of fiscal risks, diminishing the risks and the evaluation of the influence of the remaining fiscal risk and the prevention of the possibility of its setting in. The Law states that due to the existing risks in the country the reserve must be foreseen in the formation of the budget which could guarantee that the deficit does not violate the acceptable limit regardless of the risks and a certain fiscal space is retained [20], [21].

2016 was the first year when the security reserve of the financial risks was foreseen and this practice continued when working on the budget of 2017. In comparison with the previous years the risks have basically not changed. Nevertheless, the authors would like to point out that in the Budget of Social Security the expenditures have been revised in order to increase them against the previous forecasts and there is also a greater uncertainty about some expenditures in connection with Great Britain leaving the EU. So, the increase of regular payments to the EU budget is also possible.

In order to ensure the state financial sustainability it is necessary to improve the fiscal risk management. The authors consider that the attention should be paid to the fact that the fiscal risk in reality is symmetrical which is also according to the theory. It refers to the evaluation of the revenues and expenditures. It is

often so that the expenditures are not appropriately estimated, in reality they seem to be bigger, but the revenues are overestimated, they are lower than expected. At present the declaration of fiscal risks does not include the macroeconomic risks because theoretically the cyclical fluctuations of economy do not influence the structural balance but the experience of the past years shows that in practice it is not so. In the future the macroeconomic risks should be included in the declaration, too.

A typical feature of the fiscal policy in Latvia is the problem of ensuring the collection of revenues on the one side and the public pressure to increase the expenditures on the other side. The authors consider that the main point is to ensure the revenues which means a set of wide range of measures in order to develop entrepreneurship, the fight against the shadow economy, the improvement of tax policy, etc. The authors of the research do not intend to investigate all problems and measures but they will focus on the issues of the tax policy which is very topical nowadays. As it has been pointed out, the proposals of the tax reform have been made by the government and the Bank of Latvia, the greatest attention being paid to the personal income tax, the procedure of the capital taxation and the corporate income tax.

It has been estimated that as a result of changes next year the revenues in the budget will be 100 million less but net wage, for example, of an employee with a minimum wage without a dependent person, would increase by 79 euros a month. There are indications that this is the right time for the changes of the tax policy because in 2018 and 2019 the Latvian economy will receive the EU funds which will absorb the fiscal influence of the new tax policy providing the indicators of the fiscal space [18].

The reform proposed by the government actually includes the points which have already long been under the discussion in the society, such as the decrease of employment tax, the takeover of the practice of the corporate income tax in Estonia, about the change of the procedure of the capital income taxation, etc.

Conceptually, providing a positive assessment of the proposed solutions in the field of taxes the authors would like to point out that at the same time there are several questions about the efficiency and the influence of this action not only referring to the budget revenues but also to the evaluation of the development of the whole society. Besides, there is no answer to the question about jeopardizing the provision of the fiscal space of the budget as a result of reforms.

In the debate on the reforms one of the opinions was that the influence of the predicted tax reform is too optimistic [17].

In order to evaluate the proposed estimations the authors made an investigation. As the main subject of

the investigation in the field of tax changes the authors chose the corporate income tax (CIT) evaluating its influence on the state gross domestic product (GDP) and the state budget under the existing circumstances and the implementation of the proposals of the Bank of Latvia. It should be noted that in the empirical model of the economic growth the OECD researcher J. Arnold proves that the economic growth is mostly hindered by the corporate income tax [10].

IV. MATLAB/SIMULINK TOOL FOR ECONOMICS PROCESS MODELING

Simulation - the most powerful and versatile method for studying and evaluating the effectiveness of systems, the behavior of which depends on the influence of random factors [1].

The implementation of such opportunities in the universal programming language is a difficult task. Currently, there is quite a lot of software that allows to model processes. However, now there is a product that allows solving these problems quite effectively – the MATLAB package [2], [4], [6] containing a visual simulation tool – Simulink. Simulink - a tool that allows you to simulate the system quickly, get the indexes of expected effect and compare them with the amount of effort required to achieve them [7], [12].

Of particular interest for simulation is a Simulink tool designed specifically for modeling dynamical systems. It has a library of standard graphics units with built-in mathematical functions. It is sometimes called a tool of visual modeling [3], [5].

Although Simulink is designed mainly to solve engineering and scientific- technical problems, the possibilities of its use are almost unlimited. The input of initial parameters is made interactively by graphics assembly of elementary blocks circuit diagram, resulting in a model of the studied system. The blocks included in the model relate to each other both in information and in management. The type of connection depends on the type of the block and the logic of the model.

The Simulink program is an application to the MATLAB package. Using Simulink program the simulation implements the principle of visual programming whereby the user on the screen creates a model of a structure, process or system from standard blocks of the library, and performs calculations. In this case, unlike in classical ways of modeling, the user does not need to study the programming language and numerical mathematics methods thoroughly, there is enough to have some general knowledge required when working on the computer, and, of course, knowledge on the subject area in which he works.

Creating a model in this way, and then launching it, it is possible to see the results of modeling. In the simulation, the user can choose the method for

solving equations, as well as the way to change the model time (with a fixed or variable step). During the simulation, it is possible to monitor the processes happening in the system. To this purpose, special viewing devices that are part of the Simulink library are used. The simulation results can be presented in the form of graphs or tables.

In the research the future model was evaluated according to the existing legislation of the Republic of Latvia taking into account the tax reforms proposed by the Bank of Latvia "Taxation strategy 20/20" (see Table I).

Evaluating the potential forecast for the year 2020 according to the existing legislation the authors use official statistical data [19], [20] (see Table I).

Table I
GDP, CIT and the state consolidated budget revenues in Latvia in the years 2014-2019

Year	2014	2015	2016	2017	2018 (forecast)	2019 (forecast)
GDP	23600	24378	25072	26403	27905	29615
CIT	354,8	383,1	407,1	425,3	461,1	468,8
Budget	4939,2	5093,1	5281	5760,6	6336,2	6256,4

For further investigations it is needed to obtain the forecast for 2020.

Graphically depicting GDP, CIT, Budget curves, we can get trend line with equations (see Figures 1-3).

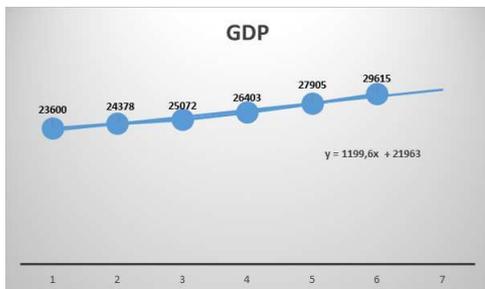


Fig.1 GDP indicator trends in Latvia in the period of 2014-2019 and the forecast for 2020

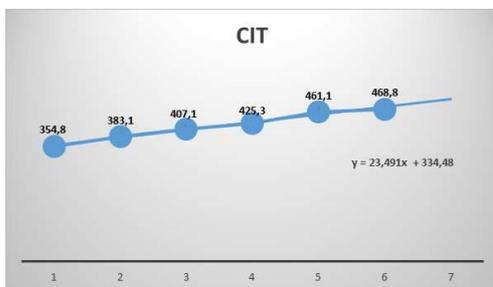


Fig.2 The revenue indicator trends of the CIT in the state consolidated budget in Latvia in the period of 2014-2019 and the forecast for 2020

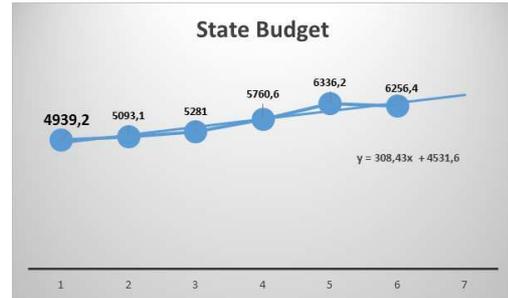


Fig.3 The indicator trends of the state consolidated budget in Latvia in the period of 2014-2019 and the forecast for 2020

Using the trend line equation the forecast for 2020 was calculated according to the legislation of Latvia [19], [20] (see Table II).

Table II
GDP, CIT, the indicators of the state consolidated budget in Latvia in the period of 2015-2019 and the forecast for 2020

Year	2015	2016	2017	2018	2019	2020
GDP	24378	25072	26403	27905	29615	30360
CIT	383,1	407,1	425,3	461,1	468,8	498,9
Budget	5093,1	5281	5760,6	6336,2	6256,4	6690,6

With the aim to make up the simulation of the CIT influence on the economy and fiscal situation in the country a simple Matlab/Simulink model was elaborated which calculated the proportion CIT/GDP and CIT/Budget (for the purpose of scaling all the results were multiplied by 100) (see Fig. 4).

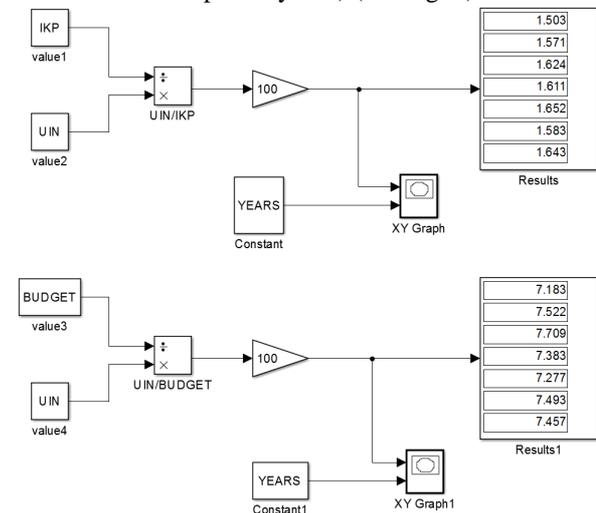


Fig.4 The evaluation model of the influence of the CIT

As a result the indicators of the CIT influence on GDP and the state consolidated budget were obtained (see Table III).

Table III
 The evaluation criteria of the CIT influence on the GDP and the state budget

Year	2015	2016	2017	2018	2019	2020
CIT/GDP	1,57	1,62	1,61	1,65	1,58	1,64
CIT/Budget	7,52	7,71	7,38	7,28	7,49	7,46

This is a graphical depiction of indicators (see Figures 5 and 6).

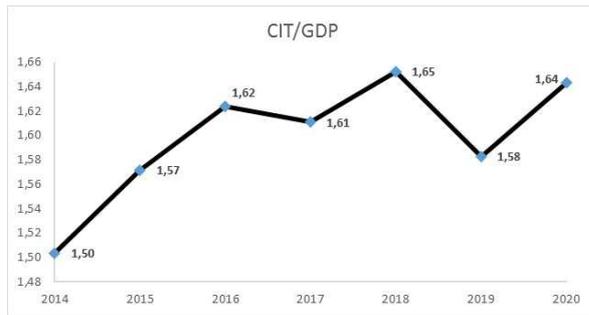


Fig.5 The influence of the CIT on the GDP according to the existing legislation of the Republic of Latvia

It can be concluded that Matlab/Simulink tool is a very suitable tool not only in the economic calculations but it can also serve as a visualization tool of a simulation model in various fields of science.

Based on the proposals of the Bank of Latvia "The tax strategies 20/20" [17] the authors have conducted an analytical research on the formation of the corporate income tax (CIT) and its influence on the economic and fiscal situation in the country.

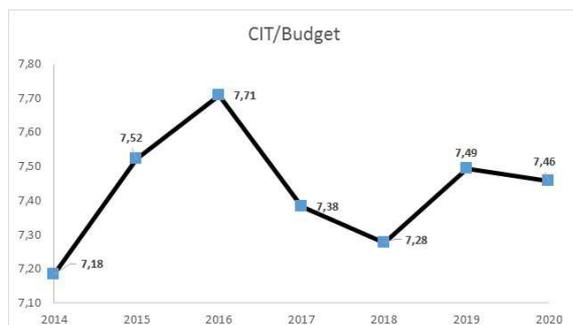


Fig.6 The influence of the CIT on the state consolidated budget GDP according to the existing legislation of the Republic of Latvia

The authors have made a simple assumption as well as made analysis of two opposite variants:

1. All enterprises invest money into the reinvested profit (i.e. 0% of the reinvested profit make a loss in the amount of 15% of the CIT income accordingly).
2. All enterprises pay 20% to the distributed profit (the CIT increase is in the amount of 5%).

In the first variant of the data modelling in the environment of the Matlab/Simulink we have obtained the following results of the first variant (see Figure 7):

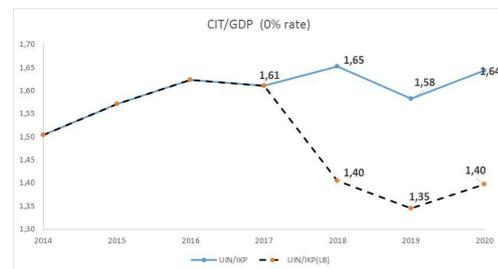


Fig.7 The CIT influence on the GDP applying 0% rate

In the second variant of the data modelling in the environment of Matlab/Simulink we have obtained the following results (see Fig. 8):

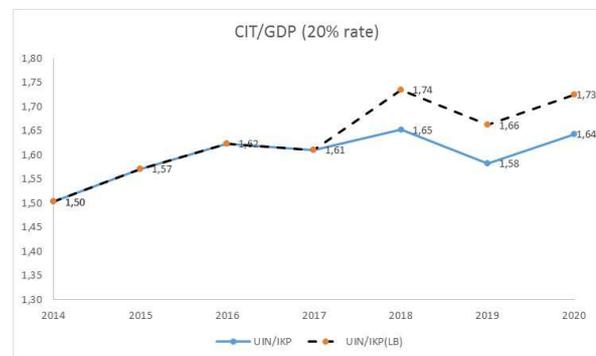


Fig.8 The CIT influence on the GDP applying 20% rate

We can make a conclusion that according to the present situation the short-term planned (2018-2019) CIT 0% rate with the assumption that it will be used by all enterprises will have a relatively negative influence on the economic activities but the future forecast is favorable in the context of the economic development.

We can make a conclusion that on the condition of 20% of the corporate income tax it could provide a greater influence on the state economic development in comparison with the present situation in the legislation of the Republic of Latvia.

As a result of the modelling of the situation the authors would like to emphasize that the cumulative influence of the CIT on the economic situation in the country will depend on certain decisions made by the entrepreneurs which will respectively influence the preconditions of the formation of the state fiscal space. The authors consider that a positive influence on the economy will be seen only in the medium term and long term because it will never be so that all the entrepreneurs will immediately decide to make investments in the development. The authors of the research are rather skeptical about the change of the attitude of the entrepreneurs referring the tax discipline in the short term. Taking into account a long time existing bad discipline of tax paying in

Latvia, shadow economy, distrust to the government reforms, the change of "the playing rules" too often, the authors suggest the government to work with entrepreneurs, discuss issues, popularize examples of good practice and consequently keep promises.

In order to make a complete evaluation of the issue it is necessary to conduct a comprehensive analysis of all the changes of proposed taxes but it is the subject of further research.

V. CONCLUSION AND PROPOSALS

The concept "state fiscal space" has only recently become topical in connection with the economic crisis which began in 2007 in the USA and later on also in the European countries. Both in Europe and in Latvia it has negatively influenced the process of the formation of the state budget increasing the deficit of the State Budget and government debt.

The concept "fiscal space" has a great capacity but, simply speaking, they are free or "released" funds in the government budgets which can be redirected to particular activities.

2016 was the first year in Latvia when in the State Budget the reserve was provided to ensure the fiscal risk and this practice continued working on the budget of 2017. In comparison with the previous years the risks are basically remained unchanged. Nevertheless, it should be noted that in the Social Security Budget the revision of expenditures has taken place against the previous forecasts and there is a greater uncertainty about particular expenditures in connection with Great Britain leaving the EU.

Of particular interest for simulation is a Simulink tool designed specifically for modeling dynamical systems. It has a library of standard graphics units with built-in mathematical functions. It is sometimes called a tool of visual modelling. The Simulink program is an application to the MATLAB package. Using the Simulink program the simulation implements the principle of visual programming whereby the user on the screen creates a model of a structure, process or system from standard blocks of the library, and performs calculations.

Evaluating the influence of a particular tax (CIT) on the GDP of Latvia and the state budget according to the existing legislation the authors can make a conclusion that the general trend is positive which provides favorable opportunities for the provision of the fiscal space.

As a result of modelling the situation of applying the proposals of "taxation strategies 20/20" of the Bank of Latvia in the field of CIT we can say that the cumulative influence on the economic situation in the country will depend on the particular decisions made by the entrepreneurs which in its turn will also influence the preconditions of the formation of the state fiscal space.

The authors consider that the attention should be paid to the fact that the fiscal risk, which theoretically

must be symmetric, in reality it is so. The question is about the estimation of the revenues and expenditures. It is often so that the expenditures are not appropriately estimated, in reality they seem to be bigger, but the revenues are overestimated, they are lower than expected. At present the declaration of fiscal risks does not include the macroeconomic risks because in economy the cyclical fluctuations do not influence the structural balance but the experience in the past years show that it is not so in practice. In the future the macroeconomic risks should also be included in the declaration of fiscal risks.

In the cooperation with entrepreneurs the government must stimulate the change of the attitude to the discipline of tax payments, to foster investments which could improve the economic development and the revenues in the State Budget.

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