THE IMPACT OF LABOR TAXATION RELAXATION ON ECONOMIC GROWTH

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Abstract

On average, fiscal policy is a relatively useful tool in market economy – respectively, for any economic strategy whose main goal is attaining/preserving economic growth. Of all components of fiscal policy, however, labor taxation (and its main tool, i.e. labor taxes*) is linked with more than one tie with economic growth mechanism, in fact being its (main) core, since* labor *is mainly what* produces *– along with capital and knowledge –, in the end, economic growth.*

Keywords: labor taxation, economic growth, fiscal policy

JEL Classification: E 62; J01.

Introduction

Labor taxation is a component of *fiscal policy* and must be analyzed as such – which means, first of all, that is must be analyzed – at least at times – to begin with: this is a component of fiscal policy seldom analyzed, given income (e.g. profit) and VAT, excises&c. are, or seem to be, much more in the spotlight, both for governments and public opinion.

Since labor taxation is part of fiscal policy, firstly, before analyzing it, we feel it is necessary to shed a light on fiscal policy itself. Well, to cut a long story short, it suffices to define *this* important macroeconomic policy as the sum of economic strategies, administrative procedures and specific tools – e.g. direct and indirect taxes – put to use in both short and long term by a government (administration) for the benefit of achieving following goals:

(1) Strategic management of market *and* (market) economy and
(2) Control of state budget funding mechanism.

The specific – and main – tools of fiscal policy are direct and indirect taxes; these are, in short, visible instruments with which two specific economic strategies – that is, specific to fiscal policy – are implemented, namely direct and indirect *taxation* (methods).

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Given the undeniable fact labor is the very core of economic growth – used as a production factor by (market) economy, that is –, it is transparently clear labor taxes, as tools of fiscal policy, labor *taxation*, in general, as distinct component of fiscal policy influences economic growth to a much larger extent than economic growth itself is capable of influencing labor taxation – not to mention any other component of fiscal policy.

Labor is taxed through labor taxes, which are *levied* on salaries and wages (and any other similar entities); in Romania, for this matter, labor taxation is supported by both:

1. employer and
2. employee.

Labor taxation is used, basically, for attaining two separate goals: first one, let us say, it the implicit one, namely funding (state) budget, whilst second goal is precisely sustaining economic growth (i.e. through propping up components of economic mechanism such as *stability* of market economy – first and foremost, of *labor market* –, promotion of strategic benchmarks such as full employment, etc.). Labor taxation works through this, in principle, *mainly* in microeconomic sphere of market economy, but the going is, mostly, tough.

It is so, due to the fact labor taxation is *supposed* – so in theory – to bolster economic growth, in short term but for the most part in long term, as final result of it enhancing efficiency of production process – for (almost) every firm and, in general, economic activity.

Labor taxation, as logical consequence, should be *designed* to *fit* into – and not to work *against* – following economic (and financial) dynamics:

I. labor tax is known to increase cost of ***labor*** firm needs and so has to *buy* – e.g. by hiring new employees –, whilst same firm must not lose sight of that venerable economic principle, according to which it must always pursue for obtaining a maximum profit with minimum expenses;
II. as consequence, at very least *its* labor demand will inexorably *tend to **decrease*** – if not initiating, or consolidating, a similar trend in the very labor market that firm is a part of;
III. final effect of labor tax is the definite tendency (if not downright positive effect) for firms to *use a smaller quantity* of labor – than before the introduction of (or increase in) labor tax.

This is only the basic picture, however; in real terms, dynamics of labor taxation *and* economic growth is more complex. For labor, as production factor, is taxed through its most easily reachable – as far as fiscal policy goes, anyway – component, namely its disbursement (since this is basically an income transfer, directed to employees), given that:

(1) taxation is a phenomenon which supplies (state) budget with (fiscal) revenues coming from not one, but two sources: on one hand, incomes of employees are taxed (i.e. salaries and wages), but, on the other hand – at least in Romania –, labor taxes are also levied on incomes of *employers*;
(2) but, since labor *offer* is characterized by relatively low levels of elasticity – viz. *geographical* mobility of employees is, on average, below any 'average' level

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> one might think of, and, besides, financial independence, so to speak, of same individuals is, on average again, even less developed –, from this perspective, it is probable that, given existence of labor taxes, *a fortiori* when these labor taxes' levels are *on the rise*, fiscal pressure that comes along with labor taxes will be supported by employees (and, thus, *indirectly*, by firms themselves), and not by employers.

Labor taxes being supported by employees is a state of *fact* which precludes any *substantial* salaries &c. growing trends: salaries, wages, etc. may rise, in fact, eventually, will (gradually) rise, but will relatively small increments. This effect, however, hits hard economic growth – if labor taxation *relaxation* is not set in in this process, with the very goal of stimulating economic growth.

As it is universally known, one of the sources of economic growth is consumption – which is, so to speak, carried out, in any market economy, by firms *and* ordinary taxpayers/employees. If the latter face declining living standards, with lower wages, their consumption will inevitably decline – at least because all these people will be very busy doing their level best in making up, or expanding, their *savings*. So, on this basis, economic growth will slow down, at best – if not (and at worst) grind to a complete halt.

Labor taxes are important – or, to put it in another perspective, potentially dangerous – to economic growth because they are levied, at least *in the(ir) design*, on a production factor; arguibly, on the most important production factor known to exist in a market economy (and in *any* economy, in general). And, given economic growth is final result of the use of economic factors, in the long run, if firms are compelled to use less (and less) labor, they will grow less (and less – again).

Of course, negative effect of a rise in labor taxes needs not be permanent – this is one of the reasons we analyze here impact of labor taxation *relaxation* on economic growth. On the other side, if this sort of fiscal downplay really happens, it will not boost economic growth with a too large of an increment – and, certainly, not for too many economic periods (e.g. years).

Because, if using labor (force) is becoming cheaper and cheaper, a market economy will grow, with simultaneous effect of reducing unemployment amplitude, but, anyway, an economy cannot grow on cheap labor force *only*, so this effect will *not* be felt in long term, nor will it boost sensibly economic growth.

These economic relationships, influences and dynamics are best described in a graphic manner – in this paper, by following figure (where t stands for labor taxes, L for quantity of labor employed, S&W for salaries and wages, Q for output, C for consumption and ε^{γ} for economic growth):

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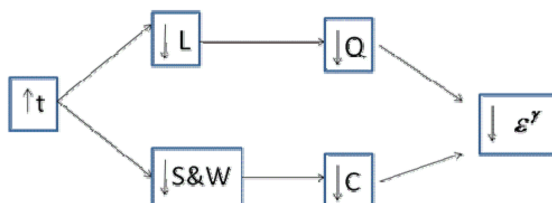

Conclusions

The impact of tax base dynamics on fiscal policy is as important as it is, in the same time, difficult to make it out with high quantitative precision; however, there are some conclusions that can definitely be drawn – viz. out of this analysis – as to the impact of labor taxation relaxation on economic growth.

Maybe most important conclusion is the *fact* labor fiscal relaxation is most surely *not* a cure-all macroeconomic (*hic*, fiscal) tool, ready to be used for insuring economic growth is and will be recorded, for protracted periods, and while nothing or almost nothing changes in the economy. Main reason for this is basic fact firms in general cannot *buy* – and, therefore, use – labor indefinitely, in ever-larger increments.

Also, it is important to take notice that low(er) labor taxes help economic growth, *if* they cause salaries and wages to rise, since this will certainly boost consumption, although to a lesser degree, due to fact phenomena such as *savings* have also to be considered.

Finally, reducing labor taxes is always all right if (state) budget can put up with it; in economies whose efficiency is borderline of sorts – such as Romania's –, budgetary policy would have to be designed into becoming really shrewd in order to cope with this, especially in long term. On the other hand, however, it is, in principle, sound to plan for economic growth whilst simultaneously coping with – or, as in *exempli gratia* U.S.A.'s economy, even *planning* for – a (growing) budget deficit.

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