Chapter 10
The Built-In Flexibility of Income and Consumption Taxes in OECD Countries

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ABSTRACT
Compatible with a variety of cyclical fluctuations in fiscal policy, is the automatic stabilising fiscal policies. There is a need to calculate the income elasticity of tax for relieving the effects of cyclical fluctuations. Income elasticity of tax, that is tax revenue have relative change, the ratio of the relative change in national income. This ratio must be bigger than 1 to label a tax system as elastic. If this ratio is bigger than 1, this situation also show the tax system has an automatic stabilizing feature. By that way, without any changes in tax structure, tax revenues increase in the deflation times and decrease in the inflation times. The automatically compensatory movement of tax revenues, generally referred to as “built-in flexibility”, has received increasing attention. The aim of this study is examining the existence of automatic stabilizers in the OECD countries by evaluating the income elasticity of income and consumption taxes and by making cross-countries comparatives.

INTRODUCTION
A taxation principle that importantly discoursed and put forward by A. Wagner (1980) for the first time is the “flexibility principle” in the taxation. According to Wagner, the taxes which are placed in a tax system must have a minimum flexibility that allow an increase equally and parallel with the increases in national income. If the taxes would not have an elasticity to correspond the changes in the public needs which are occurred as a result of cyclical fluctuations, the restriction in some public expenditures or financing the expenditures with debts would be inevitable.

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The essence of compensatory fiscal policy lies in adjusting the level of government receipts and expenditures so as to stabilize total income (and employment) in the economy. This requires an increase in expenditures and a reduction in tax revenue during periods of deflation and a decrease in expenditures and increase in tax revenue during periods of inflation. Such compensatory movements may be brought about by properly timed changes in expenditure programs and in tax rates, but to some extent they occur automatically tax yields under given statutory rates will fluctuate with changes in the national income since the size of the tax base usually varies directly with the level of income (Musgrave & Miller, 1947: p. 25).

The automatic revenue changes are described in terms of the ‘built-in flexibility’, or revenue responsiveness, of the tax. A unit-free measure of this responsiveness is the revenue elasticity of the tax; this is the percentage change in tax revenue in response to a given percentage change in income, for a constant tax structure (Creedy & Gemmel, 2007: p. 323).

Estimates of tax revenue elasticities can assist in long-run revenue forecasting. Furthermore, the built-in flexibility of taxation is known to affect the stability properties of macroeconomic models. An elastic tax acts as an automatic stabilizer; when the economy is in recession and incomes are falling (or rising slowly), tax revenues fall proportionately more (or rise more slowly), helping to maintain the growth of disposable incomes or spending (Creedy & Gemmel, 2007: p. 323).

**AUTOMATIC STABILIZER FISCAL POLICY AND BUILT-IN FLEXIBILITY**

Automatic stabilizer fiscal policy, attaches importance the impact of revenue and expenditure programs on the national income and accepts the annual balanced budget worsens the economic stability and public expenditures also cause prodigality. On the other hand, this policies worry about uncertainty that brought by the volitive fiscal policies and emphasize on the political obstacles and shortsightedness of such policies. Especially they are afraid of not to leave the programs that implemented in the depression times when the full employment occurs (Due, 1967: p. 559).

Automatic stabilizer fiscal policies has an important role on reducing the economic instabilities. By extending the application field of such policies, the need for direct measures which create uncertainties would be decrease (Due, 1967: p. 560).

In the case of existence of automatic stabilizers, there would be no need to measures and recognitions of political and managerial decision-makers for eliminating the cyclical fluctuations. With this solution, an immediate intervention occurs to solve the problem, without any lag in recognition or harvesting the results of measures (Türk, 2008: p. 103).

Automatic stabilizers are integrated in the economic system as public expenditures or taxes which relieve cyclical fluctuations in the economy.

Taxes, it is an automatic stabilizer. There is a need to calculate the income elasticity of tax for relieving the effects of cyclical fluctuations. Income elasticity of tax, that is tax revenue have relative change, the ratio of the relative change in national income ($T=\text{Tax revenue}$, $Y=\text{National income}$).

$$\varepsilon = \frac{\Delta T / T}{\Delta Y / Y}$$
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