

A Theoretical Approach of Fiscal and Budgetary Policies

Nuță Alina Cristina¹

Abstract: The overall aim of this paper is to highlight the doctrinal issues that can influence fiscal and budgetary policies decisions taken in a certain period by the public decision makers. More specifically, we want to emphasize how classical and neoclassical doctrine influences fiscal and budgetary issues. These doctrinal features should be considered when assessing a period of governance and should be related to underlying fundamentals of organization of an economy in a specific context.

Keywords: fiscal policy; budgetary policy; doctrine

JEL Classification: B12; B13; E62

1 Introduction

The classical and neoclassical doctrines have generated a fiscal policy characterized by a limited central government support, where the government was responsible for maintaining the law and order, protect property and protect the citizens against foreign intervention, state where “homo oeconomicus”, led by a “invisible hand”, pursuing its own interests, a process that determines the interests of society. Adam Smith is the founder of the doctrine, but to shape this doctrine were also joined other economists like D. Rocardo, J.S. Mill, J.B. Say. They were suspicious about the government activities, believing this activity was frequently, partisan, corrupt and inefficient, but admitted some exceptions to the general rule. The lack of state intervention was not for them an aim in itself but would increase individual freedoms, and on this basis, the “wealth of the nation” as a whole. One important finding of the classical economists, in terms of budget and fiscal policy, was that the state budget was isolated from the economic life.

2. The Classical (Liberal) Approach

For Adam Smith (1723-1790), David Ricardo (1772-1823) and James Mill (1773-1836) the economy was perceived as a self-balanced, sensitive to specific failures

¹ Senior Lecturer, PhD, Danubius University of Galati, Faculty of Economic Sciences, Romania, Address: 3 Galati, Blvd, Galati, Romania, tel.: +40372 361 102, fax: +40372 361 290, Corresponding author: alinanuta@univ-danubius.ro.

of the economic cycle, but fully able to autocorrect, without support from the government. Depressions may not be permanent because the principle “supply creates its own demand” through automatic price and adjustments of interest rates. This expression is known as “Say's Law” and claims that the excess supply of goods or the excess demand for money tend to autocorrect. Thomas Robert Malthus only (1766-1834) has some doubts about this issue.

Adam Smith was a supporter of the idea that each individual will contribute to the State in proportion to his ability to pay tax and in proportion with the revenue to each individual enjoy being under state protection. Taxation is a matter of “quid pro quo” applied to the Locke correspondence principle, (the right to use their own income), but also in correspondence with the opinion on ability to pay, as the rule of fair taxation, independent of the benefits arising from the implementation public spending.

According to the Adam Smith opinion on public debt is a direct product of its anti-mercantilist philosophy (basic idea of the mercantilist theory and economic policy was the presence and active intervention in the economy, both as an economic agent independently and support fundamental private economic agents (either internally or externally), through a thorough and severe protectionist policy for national entrepreneurs). Smith regarded the state as inefficient apparatus in terms of wealth creation and overly restrictive in terms of individual freedoms (Gheorghe, 2011). Thus, the state, in the context of the financing its spending through taxes or debt, create transfers of savings of the merchants and industrialists and also wasting money in unjustified wars, most often, which divert resources away from capital goods to public consumption. Taxes, as well as loans involving a similar diversion of resources, thus, will produce a negative trend sufficient to restrict government spending: “when a nation is already overtaxed, nothing but the need to start a new war ... or fear for national security can not cause people to tolerate a new tax.” (Smith, 1776).

In the classical conception, the loan had a negative role, because of the artificial increase of the budget and the involvement in the economy. And the most important loss is recorded when the industry and commerce trader borrows the state. Thus, public loan used to provide public budget balance in the economy reduces the disposable income that could be used productively in the private sector (Nuta, 2011). Through his writings, Smith points out an approach to the analysis of public debt that will be attacked by Keynesians, namely, that there is a load of debt from its creation, but the entire burden falls on future generations.

The only classic that has not agreed to such debt implications was Thomas Robert Malthus witch arguing that debt, once created, is not the greatest evil, since even the greatest forces of production are almost useless without a consumer. It would be irrational to determine in certain circumstances that a sudden reduction of

national debt and elimination of taxation must necessarily result in an increase of national wealth. Malthus opposed to welfare transfer system in order to support the poor, because, in his opinion it would be counterproductive.

In the field of fiscal and budgetary resources policy, J.S. Mill founded “sacrifice theory” according to which the state take some of the revenue of the taxpayer, causing him to sacrifice for the public expenses. He believes that to achieve tax justice, the criterion to be used is that of equality of sacrifice, without making any distinction between individuals and social classes, being a proponent of proportional income taxation.

David Ricardo shares Smith antipathy to the call to liabilities created by budgetary deficits. Ricardo is more trenchant than Smith about who should bear the burden of debt financing. Effects of annual transfer from taxpayers to borrowers should depend on how these categories of payers will employ these resources. According to the economist, future tax payments will be capitalized entirely by rational citizens. In this sense, Ricardo distances itself from the Adam Smith. The choice of the financing public spending modality through debt rather than through taxation will not change the real cost of government spending over the years. Ricardo made claims about the equivalence of taxes and debt, but argued that individuals do not behave with perfect precaution like the businessmen who of the hypothetical example in his work. Finally, Ricardo anticipated the “public choice” revolution, recognizing that a large national debt may give reasons to taxpayers to change the tax burden in the account of others. “A country that has accumulated a large debt is placed in an artificial situation ... is in the interest of every taxpayer to withdraw his shoulder from the tax burden and give support payment from his account to another account and the temptation is to move it along with its capital in another country, which would be exempted from such duties becomes irresistible (Malthus, 1826). Some authors (Rowley, et.al., 2002) believe that, especially through this quote, so-called “Ricardian equivalence theory between debt and taxation”, which flows in the 70s shows a misunderstanding of Ricardo's views on this subject.

The importance of the traditional doctrine for the content of the fiscal and budgetary policy issues is given by the sets of principles of fairness and justice of taxation outlined by economists who have served this doctrinal orientation. Thus, Adam Smith first proposed four principles relating to the justice of taxation, taxation certainty, or the tax return. On the other hand, J.S. Mill proposes two principles to be reflected in the fiscal policy of the liberal, namely the principle of justice, supported or implemented by imposing corresponding equal sacrifice, and the principle of neutrality. A continuation of efforts on the same trajectory has performed A. Wagner, who was considered a liberal with social views, which formulate the higher imposition principles, of a particular importance to fiscal policy. These include the principles of financial policy, public economics principles, principles of tax equity and fiscal management principles, which

complement the maximal proposed by Smith and clarifies fiscal policy actions in the classical view.

Essentially, classical liberal doctrine had a major impact on fiscal policy pursued by the state, creating a solid framework for action with justification, criteria and factors that determined the improvement of the wealth and income distribution in society.

3. Neoliberal (Neoclassical) View

One of the most important fiscal policy issues presented by Friedman (Friedman, 1957) was the necessity, existence and the scope of public spending, meaning if this component meets an active role in the overall budget and fiscal policy, knowing the fact that Keynesian oriented governments have relied on increase public spending, considering them fundamental to social and economic development. From this perspective, the monetarists have concluded that despite short-term positive effects generated by public expenditure, on the long term this is the source of the private sector, generating instability in the economic environment.

Nobel laureate, Milton Friedman, said that bureaucrats will not spend taxpayers' money as taxpayers themselves could do it, arguing that, monetary policy would be the most important determinant of the economic activity. As the great economist argued with conviction about the importance of short-term money supply, and also maintained long-term currency neutral, saying that long term money only affects prices but not real economic activity. "The first and most important lesson we learn from history about what monetary policy can do ... is that monetary policy can prevent the money themselves become a source of imbalances" (Friedman & Schwartz, 1963).

The neoclassical synthesis was devastating by Friedman attacks in terms of the existence of a stable Phillips curve between inflation and unemployment. Speaking at the 1967 European Association of Economics, Friedman rejected the original Phillips curve theory because it is based on nominal variables and not on real labor market. According to Friedman, the long-term Phillips curve is vertical and does not require a trade-off relationship between inflation and unemployment.

Short-term Phillips curve, redrafted by Friedman as "rising expectations" is stable only in the presence of natural unemployment rate. If the government acts to put the unemployment below the natural unemployment rate, short-term Phillips curve will rise giving an inverse relationship between inflation and unemployment. Government can restore short-term Phillips curve in order to escape the inflation forecasts.

Milton Friedman said that better results can be achieved if decisions are based on rules rather than discretionary decisions of government officials. A specific policy rule is automatic adjustment policies as a result of macroeconomic conditions (Turtureanu, 2011). Discretionary policies are explicit policy decision taken after consideration of economic circumstances and designed to influence the macroeconomic equilibrium.

Thus, the economist is against state interference in pricing level, against subsidies to industry and agriculture, against rising property taxes and budget deficits, as against “general welfare state”(Suta-Selejan, 1994), arguing that fiscal policy cannot ensure economic stability, since the content is not sufficiently well known (Filip & Onofrei, 2001).

Along with Friedman monetarism there are other options. One is the budgetary monetarism version promoted in the U.S. by K. Brunner and A.H. Meltzer and in Britain by Professor Minford. (Brailean, 1998). The supporters of Friedman monetarism reproaches to Friedman that budget and fiscal variables was neglected into the macroeconomic analysis, rejecting the idea that “only money matters”. They argue that the budgetary deficit also exerts an influence on production and prices levels, and its structure directly affects the Phillips curve position on the short term. In this sense, the budgetary monetarism considers that money supply shall be determined in the budget process.

The monetarism had a particularly large audience in the late '70s. Milton Friedman exerting a strong influence on government policy led by Ronald Reagan (helped, however, by Arthur Laffer), and by Margaret Thatcher. Friedman was a good adviser to Presidents Richard Nixon and Gerald Ford.

In the early 80's, in reaction to the Keynesian theory, which insisted on state intervention in the economy, has formed a new theoretical orientation so called “supply-side theory”. The main representatives of this orientation are: Arthur Laffer, Paul Craig Roberts and Norman Ture. The fundamental problem of this theory is about productivity stagnation caused by Keynesian policy. This stagnation is due largely to a tax system that destroys initiative and cause distortions on the rewards of the production factors owners and therefore over the allocation of community resources (Beaud & Dostaler, 2000).

The supply-side economists focus their attention naturally on the development and implementation of budgetary and fiscal policies that encourage saving, investment and boost employment at the highest possible growth rate. Concrete, supply-side economics is based on two key ideas (Miller & Van Hoose, 2003):

- The government is less efficient than private sector in the allocation of savings and capital investments;

- Government budgetary and fiscal policies have important effects on the incentives that influence capital accumulation and employment growth and therefore economic growth.

Regarding the tax aspect of budgetary and fiscal policy, in accordance with the theory of supply-side, tax cuts would raise the disposable income of the taxpayer's. This would increase the supply of labor and capital and the innovations and productivity levels. Arthur Laffer has shown a relationship between tax rate and the tax revenue, which shows that if it exceeds a certain level of tax rate, any new marginal tax rate leads to reductions in tax revenue due to reduced economic activity and the appearance and development of underground economy. This relationship is called the "Laffer curve". This famous curve brings a new approach to fiscal and budgetary policy issues. Once it was shown that a rational justification is need for choosing a tax rate to maximize tax revenue attracted to public financial funds and that an increase in rate does not always increase tax revenue collected.

Income taxes are paid by both households and corporations. Households are the primary source of savings driven mostly by private equity funds. According to the supply-side theorists, taxation disadvantage both savings and investment, reducing capital accumulation and economic growth. It can be seen that reducing the effective tax rate for savings to encourage households to save at any given real interest rate. Furthermore reduction into tax rate on investment allows investors to invest, regardless of interest rate. The effects of a reduction in tax rates of investment and savings, corresponds to an increase in the savings and investment balance. Supply-side economists argue that tax rates over income earned from savings and investment should be reduced, even to the exclusion, because the income tax systems have effects on employment, which could hamper economic growth. Such a reduction in marginal income tax rate of households gives reason to offer more services (labor) to any given real salary level, so labor supply curve will shift to the right and cause an increase in employment work balance, resulting in an increase into the real output.

Most of the supply-side economists favour a limited role of government. However, they recognize that there could be collective benefits by maintaining certain government functions such as national defense, public safety, and others. In this respect, if income taxes would be eliminated, other sources of taxation should take place. Some authors are in favour of replacing the income tax system with taxes on consumption, such as sales taxes or VAT. A common argument against the sales tax is that it can be regressive. Thus, it may be that people with low incomes to spend that income on sales taxes while people with high incomes be able to save or earn income free of charge from capital gains and investment.

In terms of the budget balance policy, supply-side economics, has issued the opinion that large budgetary deficits can block private spending. By inducing an

increase in the interest rate, the costs resulted of a state loan, reduce private investment. If saving increases together with the increasing rate, then private consumption may also decrease. This is the crowding-out effect, representing a transfer of resources from the private sector to government sector. If private investments attract capital accumulation, higher than government spending, the long-term growth may be slowed by the cost generated by the deficit.

In the classical model, the surplus results in a reduction in interest rates to stimulate private investment. Meanwhile, private savings decrease, so private consumption will increase. However, in the classical model, an increase in government savings, in the form of budgetary surpluses, induce an equivalent increase in private spending. Then, the increasing private investment tends to encourage capital accumulation and raise growth rate. But, by maintaining a surplus, the public savings are in the individuals' interest: to establish fees to cover their excess, and then channel the unspent fees to financial markets. Criticism concerning government surpluses occurred at the government's ability to channel these enforced savings for productive destinations.

4. Conclusion

The classical and neoclassical economists' underlines the necessity to reduce / limit the state in the economy, and this translates into a lower volume of taxes and public spending, analysis focusing mainly on microeconomic dimension.

The budgetary and fiscal policies transmission effects on aggregate supply is based on the reducing the taxation that boost the interest to work and of course this will generate an additional investment of national income in terms of an inflationary context. The long-term analysis is a short-term extension of the premises referring to the positive response of aggregate demand to offer higher, even if the level of the price increase.

5. References

- Beaud M., Dostaler G. (2000). *Gândirea economică de după Keynes/Post-Keynesian economic thinking*. Bucharest: Eurosong & Book.
- Brăilean, T. (1998). *Monetarismul în teoria și politica economică/ Monetarism in economic theory and policy*. Iasi: Institutul European.
- Carlstrom, C. T. (2006). *Milton Friedman, Teacher, 1912-2006*. Federal Reserve Bank of Cleveland. Economic Commentary.
- Filip, Gh., Onofrei. M. (2001). *Politici financiare/Financial Policies*. Iasi: Sedcom Libris.
- Friedman, M. (1957). *A Theory of the Consumption Function*. Princeton: Princeton University Press.

Friedman, M., Schwartz, A., J. (1963). *A Monetary History of the United States, 1867-1960*. Princeton: Princeton University Press.

Gheorghe, S. (2011). Doctrines and Contemporary Economic Theories in the Economic Development. *Acta Universitatis Danubius. Œconomica*, Vol 7, No 2.

Malthus, Thomas Robert (first published in 1826). *An Essay on the Principle of Population, A View of its Past and Present Effects on Human Happiness*, Sixth edition. London: John Murray, Albemarle Street.

Miller, R.L., Van Hoose, D. (2003). *Macroeconomics*. Third Edition. Theories, Policies and International Applications. Ohio: Thomson South-Western.

Nuta, F.M. (2011). Public environmental spending and the economic growth in Romania. *EuroEconomica*, Vol 29, No 3.

Rowley, C..K, Shugart, W. F, Tollison, R.D. – *The Economics of Budget Deficits*, Volume I, Edward Elgar Publishing Inc., Northampton, Massachusetts, 2002;

Smith, A. (1904). *An Inquiry into the Nature and Causes of the Wealth of Nations*. Fifth edition. First published: 1776. London: Methuen and Co., Ltd., ed. Edwin Cannan.

Sută-Selejan Sultana (1994). *Doctrine și curente în gândirea modernă și contemporană / Doctrine and Currents in modern and contemporary thinking*. Bucharest: All.

Turtureanu, A.G. (2011). Aspects of Global Crisis. *Acta Universitatis Danubius. Œconomica*, Vol 7, No 3.