

## **THEORIES AND MODELS OF FISCAL POLICY**

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### **Abstract**

*Within the paper "Theories and models of fiscal policy" we made a presentation of the main fiscal theories elaborated by the renowned representatives of the Physiocratic School, of the classic English School and last, but not least, the neoclassic approach of the aforementioned in the vision of Frank Ramsey and Arthur Laffer.*

*The purpose of the paper is to highlight which was the contribution of the fiscal theories and models formulated by scholars and to what extent they contributed to developing the economic society or to improving the quality of the research activities suitable to the field.*

**Keywords:** fiscal system, national income, national wealth,  
simple reproduction.

### **1. Introduction**

The need to know and understand about the way in which the fiscal system operates turned into the main concern of the scholars once the first theoretic approaches attempted to explain the utility of taxes, of establishing their optimum level and some aspects about their gathering and collection.

In this context was highlighted the role of fiscal policy in establishing the limits about fiscal duties, the differentiation criteria about

the “fiscal treatment depending on the ownership firm, legal form, economic branch, geographic area or headquarters of the economic agent”<sup>1</sup>

Thus, is noticeable the contribution of the Physiocratic School through its representative François Quesnay who, next to other remarkable Physiocratic scholars have “analysed the economic activity under the form of some continuous flows of incomes, considering that they could represent various circuits based on a synthetic picture. At the same time, they developed the first model of simple reproduction of social capital at national level”<sup>2</sup> and, due to this new approach, the Physiocrats, under the guidance of Quesnay were regarded as “founders of the mathematic economic school”.

Another contribution brought to the development of fiscal theories into economic doctrines was marked by the liberal trend through the contribution of classic economists such as Adam Smith who analysed labour, nature and capital as essential components in shaping the national wealth, these representing the background for constituting the incomes of the state, or David Ricardo who became noticeable by formulating the quantitative theory of money, or the dynamics of the financial rent.

Still, in completing the studies developed during classicism, the neoclassic synthesis of the fiscal theory introduces new concepts, such as the arithmetic and economic effect formulated by Arthur Laffer.

## **2. The State and taxation in the approach of the Physiocratic School**

The Physiocratic School represented by a group of French economists contributed to the development of modern capitalist economic analysis by introducing a series of innovative ideas in the economic theory. Thus, the new ideas promoted by the Physiocrats aim: the natural order and natural laws of economy, the shift in explaining wealth from the sphere of circulation into the one of production, or reproduction and balance analysis at the level of the national economy.

In the opinion of Physiocrats “the natural order and natural laws of economy” represent the backbone of their thought, so that the development of society follows a natural course, obviously provided for by Divinity with the purpose of ensuring “happiness” of mankind, reasoning representing only one of its features. In arguing this concept, Quesnay states that “each

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<sup>1</sup> Bistriceanu GH., Popescu Gh., „*Bugetul de stat al României*”, Editura Universitară, București, 2007, pg. 323;

<sup>2</sup> Popescu Gh., „*Evoluția gândirii economice*”- ediția a III-a, Editura Academiei Române - București, Editura Cartimpex – Cluj, 2004, pg. 102;

human being must obtain the highest satisfaction with the smallest possible expenditure this is the perfection of economic management. And when each does the same, this order instead of being disturbed shall be, to the contrary, ensured.” Consequently, the conception about the “natural order” and “natural laws of the economy” created by complying with the ownership and freedom principles, and the harmony of interests constituted the essential argument in defending economic liberalism against mercantilism.

Another topic subjected to the research of the Physiocrats was represented by the wealth and its source in production, and closely related to that in finding a new definition for the net output.

The hypothesis of the theoretical construction elaborated by Quesnay was supported by the fact that wealth does not consist in money, but in the useful goods that can satisfy various human needs and, in conclusion, just one branch of activity was apt to ensure “consumable goods, without altering the source where they come from - agriculture.”<sup>1</sup>

But agriculture implies two production factors: nature and labour, yet in the opinion of Quesnay only nature can be regarded as a source of wealth, the labour representing the simple contribution of the human being in changing goods created by nature. To support this concept, F. Quesnay appreciated that wealth is constituted from: “natural wealth”, in other words subsistence goods and raw materials, and “industrial goods”, hence manufactured goods, but industrial wealth implies creating natural wealth, hence the true and unique wealth is the one which “is yearly reborn from Earth”.

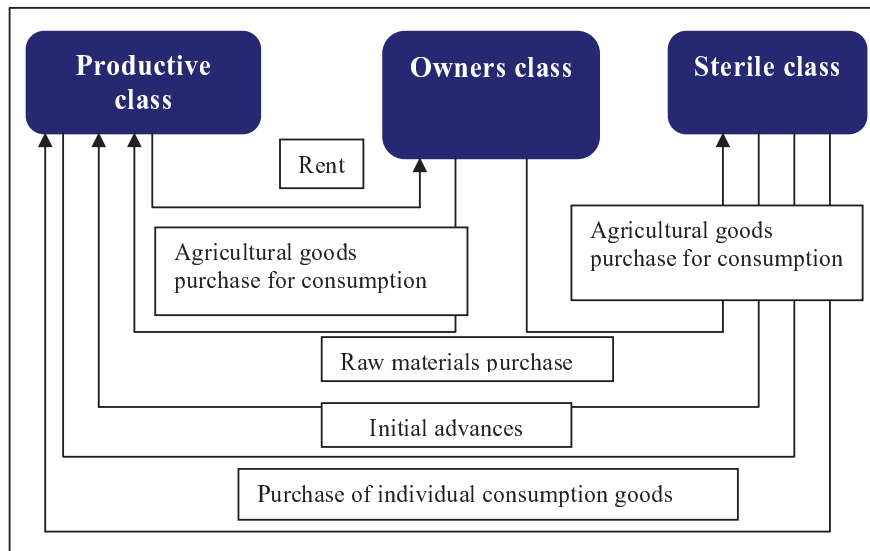
This current of thought – which did not last but three decades (1750-1780) has still played an important role in the history of economic theory and practice.

Among the characteristics that establish the place of Physiocrats in the long-term history might be reminded also the one that they were the first to analyse the economic activity under the form of some continuous flows of incomes – shifting from one population class to another – and have considered that they can represent the various circuits by a synthetic, schematic picture – “The Economic Picture” which is represented in Figure 1.

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<sup>1</sup> Popescu Gh., „Evoluția gândirii economice”- ediția a III-a, Editura Academiei Române - București, Editura Cartimpex – Cluj, 2004, pg. 106;

Figure 1 F. Quesnay's Economic Picture



**Source:** Lupan M., „Istoria gândirii economice”, Universitatea Ștefan cel Mare, Suceava, Fcaultatea de Științe economice și Administrație publică, 2009, pg. 18-19;

Also, the Physiocrats have elaborated the first model of simple reproduction of social capital at national level, reason for which some followers considered them “the founders of the mathematic economic school”<sup>1</sup>.

Thus, in the thinking of the founder of the Physiocratic School the economic circuit was realised just in real terms as different from mercantilists who developed a monetary theory, the moneys having the significance of an exchange mean, and not of a component, or source for wealth formation.

<sup>1</sup> For the first time in the year 1890 the professor Stefan Bauer (the one who discovered Tableau economique) in the article published in „Journal of Quarterly Economics” made such considerations. Thereafter, in 1896 August Oncken (1844-1911) wrote in the “Economic Journal” the article *Physiocrats as founders of the mathematical school*, and Charles Gide and Charles Rist appreciated that “Quesnay resorted to arithmetic calculations for explaining his picture and that gives him the right – to a certain extent – to be regarded as the precursory of the mathematic economic school”. Subsequently Alois Schumpeter called the Physiocrats “the founders of econometrics”;

The conception of the Physiocrats about the repartition of the social product correlated with the necessity of forming income sources at state level constituted the premises for the Physiocrats of formulating a new original theory about taxation.

From the viewpoint of the role of state in economic life, Physiocrats consider that the national income has as single source the net product because in their opinion taxation of the net product does not affect the conditions of simple reproduction. Following this conception, their vision is developed into elaborating new theories much closer to the economic reality based on the idea that “the state budget feeds through several channels and that in history there never existed a system of flat taxation, but one of multiple taxation”<sup>1</sup>.

### 3. Contribution of the classic English School in developing fiscal policy

In developing the theory, the freedom of competitiveness represents the background of organising social relations. Also, A. Smith noticed that between social order and economic order there is a series of contradictions, due to individual interests, but accepts it by maintaining that “freedom of action of individuals is the condition of any progress...and injustice triggered by economy’s freedom is not as high as it seems.”<sup>2</sup>

In this context, the reasoning at the basis of the principle of “the invisible hand” takes into consideration the issue of market prices’ oscillation, due to – according to the opinion of A. Smith, the author of the masterwork “The Wealth of Nations” – the relationship between demand and supply of wares.

They consider that if on market supply exceeds the value of demand, then the prices shall register a decrease, fact which shall influence production, as it will be discouraged. Under the situation in which demand is superior to supply, then the prices shall register an increasing trend, and thus production will be stimulated. As result, only under these conditions the balance is achieved spontaneously – by means of competition and not by intervention of the authorities, ensuring thus social progress, and each individual contributes involuntary to achieving the general interest.

Analysing the researches made by Adam Smith, it might be concluded that for obtaining welfare and ensuring the balance, the market

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<sup>1</sup> Popescu Gh., „Evoluția gândirii economice”- ediția a III-a, Editura Academiei Române - București, Editura Cartimpex – Cluj, 2004, pg. 120;

<sup>2</sup> Văcărel I. Bistriceanu GH., ... „Finanțe publice”, ediția a VI, Editura Didactică și Pedagogică, 2007, pg. 132;

must operate freely, without the direct involvement of the state in the economic life.

Starting from the premise that the state has only responsibilities pertaining to protecting and defending the interests of the society, together with the development of the economic-social plan this responsibility becomes increasingly costly; as result the expenditures register an increasing trend becoming increasingly more difficult to assume, fact which triggers the necessity of supporting them by the general contribution of the entire society, a contribution materialised under the form of taxes and duties, that would answer to certain requirements and principles.

In this context, it is noticeable the particular contribution brought by A. Smith to developing taxation, as he used for the first time in the economic theory and practice, the fiscal policy as instrument of stabilising the economy, formulating four principles that should be pursued in establishing taxes, principles that are maintained even today, as well as the role of public finances.

Hence, in the respective period the role of public finances was the one of ensuring the procurement of necessary resources for the maintenance and functioning of public institutions, and the methods used for the formation of these resources were conceived as having at their basis the principle of fiscal neutrality, which in the perception of the Scottish origin classic signified “the indifference of taxation against the economic structure of the production means,<sup>1</sup>” so that cashing of taxes should not affect the mechanism of prices’ formation, the economic-social relations or the balance between the incomes and expenditures of the state, considered as “ a fundamental requirement of well management, the key of public finances”<sup>2</sup>.

#### **4. Neoclassic synthesis of fiscal theory**

In the neoclassic theory of taxation, emphasis is laid on finding an efficient way of cashing taxes. During this period is remarkable the contribution of Frank Ramsey who considers that “the highest taxes must be applied to those entries or exits that have the highest inelasticity of the price

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<sup>1</sup> Bistriceanu GH., Popescu Gh., „*Bugetul de stat al României*”, Editura Universitară, București, 2007, pg. 328;

<sup>2</sup> Văcărel I. Bistriceanu GH., ... „*Finanțe publice*”, ediția a VI, Editura Didactică și Pedagogică, 2007, pg. 28-29;

in relation to supply or demand”<sup>1</sup>, thus obtaining an increase of the incomes without registering significant efficiency losses.

From Ramsey’s approach is noticed the importance of finding an optimum way of establishing the taxable matter and of the taxation amount with the purpose of highlighting the main functions that must be fulfilled by the fiscal policy in view of increasing public incomes, considered as “the most important source of financing public expenditures even if they are not the sole financing sources of the latter”<sup>2</sup>

By adopting the fiscal-budgetary policy promoted by Ramsey, the government establishes the taxation rates of incomes from labour and used for covering public debt and financing governmental consumption.

Short time after the studies developed by Ramsey, “the father of the economy on the supply side”, Arthur Laffer made himself noticed on one hand based on the opinion according to which the diminishment of the taxation rate implies a diminishment of incomes from taxation, so that the arithmetic effect is obvious and, on the other hand, the diminishment of the taxation rate can determine an increase in labour and production, fact that would lead to increasing public incomes, hence the emergence of the economic effect.

Starting from the idea that „ What is simple and small is nice and beneficial”<sup>3</sup>, referring to diminishing taxation, he developed a theory regarding the amplitude of the taxation rates.

The economist A. Laffer, considers that ‘beyond a certain ceiling of taxation rates, any increase of the latter generates diminishment of collected budgetary incomes, being necessary – as consequence – the diminishment of the respective rates for obtaining an increase in the budgetary incomes.’<sup>4</sup>

In supporting his theory, by using mathematical reasoning based on the model of the market economy of the United States, A. Laffer “built” a curve with the same name, through which he proves that when an increase takes place in the taxation rates, an increase is obtained for fiscal cashing, yet only up to a certain level, called the maximum or optimum point, beyond which any increase of the taxation rate shall generate a decrease in

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<sup>1</sup> Samuelson P.A., Nordhaus W. D. , „*Economie politică*”, Editura Teora, București, 2000, pg. 380;

<sup>2</sup> Duca A., „*Miraculosul triumfi al impozitelor*”, Editura ASE, București, 2007, pg. 67;

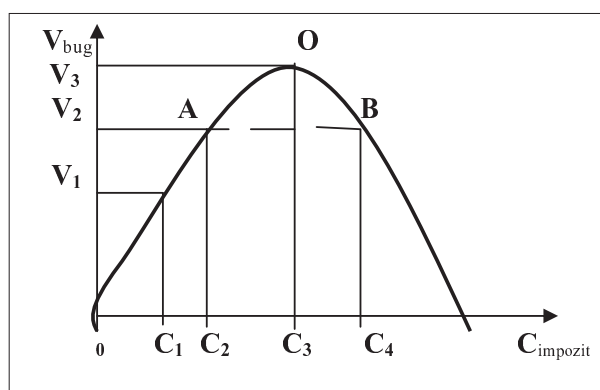
<sup>3</sup> Laffer A., „*The Laffer Curve: Past, Present, and Future*”, June 1, 2004 , The Heritage Foundation, USA, <http://www.heritage.org/research/reports/2004/06/the-laffer-curve-past-present-and-future>;

<sup>4</sup> Văcărel I. Bistriceanu GH., ... „*Finanțe publice*”, ediția a VI, Editura Didactică și Pedagogică, 2007, pg. 653;

collected budgetary incomes, so that the American professor succeeds in highlighting the correlation between fiscal incomes of the state and the taxation rates.

In the specialised literature of public finances is found the classic form of the Laffer Curve (the reversed form of letter “U”, or the portion from quadrant I for the coordinates’ axes  $xOy$  of a second degree function  $2: f(x) = ax^2 + bx + c$ , cu  $a < 0$ ) (Figure 2.). Nevertheless, various experts in the field, among which Malcolmson (1986) maintain that discontinuities are possible for the cashed rates of taxation.

**Figure 2. Laffer Curve**



The analysis of the diagram from Figure 2 highlights the fact that under the conditions of a progressive increase of the taxation rate from  $C_1$  to  $C_3$ , a superior volume is obtained for budgetary incomes -  $I_1$ ,  $I_2$  and  $I_3$ , yet the increasing trend is maintained up to the level of the point of maximum – “O”, and from this point on the constraint effect becomes predominant, as compared with the income effect, as result any subsequent increase of the taxation rate, in the graph point  $C_4$  shall generate a diminishment of the incomes of the state.

In conclusion, tax payers under the influence of the fiscal burden pressure shall resort to illicit practices, for avoiding the payment of fiscal duties, fact that will trigger a diminishment of the economic growth rate and, consequently, a decrease in budgetary incomes.

## 5. Conclusions

The permanent process of redefining the fiscal theories and models has taken various forms in the economic theory and practice in time. So that terms such as wealth, production or defining the net product were the



beginnings for outlining the first elements of a fiscal policy that will become the main instrument for maintaining macroeconomic equilibrium.

The classic and neoclassic approach of the economic doctrine about taxation, correlated with the analysis of macroeconomic indicators, as well as of the main mathematical models regarding fiscal policy have underpinned the perfect role played by taxation in the process of economic growth researched by the representatives of the Physiocratic School or of the classic English School, and subsequently in developing the theory of the general equilibrium which had as promoters John Maynard Keynes and Paul Anthony Samuelson.

Currently, the outcomes of formulating and applying the fiscal theories and models was materialised in the delineation of the action sphere of fiscal policy, respectively the repartition process of the “relationships that emerge in the process of public funds’ of financial resources formation and direction in view of satisfying social needs”<sup>1</sup>, and in establishing the objectives pursued systematically that can influence all other phases of social reproduction, among which we remind production, exchange or consumption.

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<sup>1</sup> Văcărel I., Bistriceanu GH., ... „*Finanțe publice*”, ediția a VI, Editura Didactică și Pedagogică, 2007, pg. 110;

