THE IMPLICATIONS OF ECONOMIC THEORIES IN FISCAL POLICY IN TERMS OF GOVERNMENT EXPENDITURES

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Abstract

The economic theories are considered desideratum in identifying the main problems of ensuring fiscal sustainability. The present study is a theoretical one and its purpose is to make an in-depth analysis of the economic theories that were imposed in determining the instruments for applying fiscal policies, focusing in particular on the implications brought by government expenditures. Thus, results revealed that the economic theories will remain only a foundation in the application of fiscal policies, and the most important aspect regarding the identification of the economic reality is given by its in-depth study.

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1. Introduction

This study analyses the theories and empirical results of research that underlie the application of fiscal policy. The importance of using such a research method is given by the need to identify the current state of the

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information horizon given by this niche. In the first phase, the aspects related to economic theories will be substantiated in order to identify the hypotheses regarding the usefulness of government expenditures in the application of fiscal policy. These theories are the pillars in the formation of fiscal policies and in defining the main types of savings. The present study is a theoretical one, and its purpose is to make an in-depth analysis of the economic theories that have been imposed in determining the instruments for implementing fiscal policies. A retrospective on fiscal policy theory, government expenditures theory, classical economic theory, Keynesian theory, new Keynesian theory, new classical economic theory, as well as real business cycle theory will allow a complex comparative analysis of the whole set of hypotheses identified. The theoretical framework will contribute to establishing the direction of research and achieving the proposed objectives by comparing the hypotheses identified in economic theories and distinguishing the most relevant models based on a comprehensive review of the literature. It will also help to create a solid scientific basis for interpreting and explaining existing economic phenomena related to the applicability of fiscal policy in a European transnational framework.

This paper is structured as follows: section two includes the theory of fiscal policy, section three includes a complex analysis of government expenditures theories, section four makes a foray into classical economic theory, section five contains aspects of Keynesian theory and fiscal multipliers , the sixth section describes the characteristics of the new Keynesian theory, the seventh section refers to the characteristics of the new classical economic theory, the eighth section contains references to the theory of the real business cycle, all followed by a section of conclusions.

2. Fiscal policy theory

Fiscal policy is based on the theories of the British economist John Maynard Keynes set out in his famous paper *The General Theory of Employment, Interest and Money* from 1936. In his view, fiscal policy is used to balance fluctuations in the business cycle by using two fiscal instruments, government expenditures and revenue. These will produce a domino effect, as the reduction or increase of taxes and expenditures will influence the aggregate demand and, implicitly, the level of economic development.

Although the concept of fiscal policy has appeared countless times in this theorist's book, its significance and applicability have not been fully understood. However, Keynes theorized at an early stage the effects of fiscal policy on the functioning of an economy. Colm (1950) also refers to Keynes' way of defining fiscal policy, stating that he "never gave a formal definition of fiscal policy". The term fiscal policy was also used before 1936. In the years following the emergence of Keynes's General Theory, fiscal policy was transformed into a form of public policy, becoming a subject increasingly studied in the major economics schools of the world. The first tax policy course called Economics of Fiscal Policy was held at the University of Chicago in 1934 by Alvin Hansen and John Williams. Among the objectives pursued in these courses were the achievement of topics such as business cycles and their consequences, income distribution and the composition of the national budget. In the works written by Musgrave (1959) and Johansen (1965), fiscal policy is seen as a tool for income redistribution and resource relocation.

The historical evolution of the term fiscal policy has been abrupt due to the growing debates in empirical studies. The definitions and classifications attributed to fiscal policy have transformed it into a theoretical system of directing and harmonizing economic fluctuations. From the systematization of the issues addressed over time, the theoretical concepts presented by Keynes have remained valid, according to which fiscal policy uses incentives to act, such as government revenues and expenditures, with direct implications on the process of intermediation between government and the real economy.

3. The theory of government expenditures

The role that government expenditures plays in the process of economic development has been a captivating topic among tax theorists. Economic history encompasses a series of events that took place as a consequence of the implications of fluctuations in government expenditures. An example is given by the Great Recession of 1929-1930, when worldwide, economies were affected by rising government expenditures. Among the oldest theories about their consequences was the one developed by Adolph Wagner in 1893. Through his work he managed to implement a law to increase government expenditures called Wagner's Law or Wagner's Hypothesis. Musgrave and Musgrave (1989) state that Wagner anticipated the trend of applying such a law and that it will only have long-term effects, namely in 50 to 100 years, and the development of modern industrial society will lead to increased political pressure for social progress and continuous growth of the public sector.

Dalton (1922, p. 19) presents in his book *Principles of Public Finance* a new perspective on government expenditures, known as the Dalton Condition. According to it, "government expenditures, in any direction, must be done from afar in such a way that the commitment of the community of a small increase in any direction is the balance of the disadvantage of a small increase corresponding to the taxation of revenues from any other source of public revenue."

Ten years later, Pigou (1932, p.87) in his book *The Economics of Welfare*, attributed to economic welfare two distinct elements, distribution and production. Thus, the economic theory of government expenditures receives a new perspective called the Pigou Condition. According to this, economic prosperity does not only come from an increase in taxes and fees. They must be a means of acquiring certain social services or programs by respecting the phrase social costs - social benefits.

Howard Rothmann Bowen in 1943 laid the foundations of another theory of how government expenditures is distributed in a society in which social goods and services are not evenly distributed to all voters. In his paper *The Interpretation of Voting in the Allocation of Economic Resources*, he raises the issue that public goods and services are consumed by citizens and not everyone contributes to them. In this sense, the degree of satisfaction is universally applicable to the entire population, causing inequity. Regarding Bowen's assertions as a contribution to substantiating public finance issues, Samuelson (1954) argues that he did not neglect the theory of optimal public expenditures, unlike other economists who have wasted much of their energy on taxation theory.

The critical limit theory founded by Colin Clark in 1945 would create a series of debates among theorists and practitioners in finance. Its name is given by the very limit of government expenditures, which in Clark's view should not exceed 25% of gross domestic product in order for a country's inflation and budget to be balanced. Another theoretical aspect related to the nature and usefulness of government expenditures was introduced by Paul A. Samuelson in 1954. He presented in exactly two and a half pages, as he himself stated “a pure theory of government expenditures on collective consumer goods.”(p. 388), and in 1955 it will come with short additions related to its initial theory.

A theory that dismantles the hypotheses of Wagner's Law mentioned earlier in this subchapter was introduced by Peacok and Wiseman (1961, p. Xxiii), who, although he considers it productive in some places, is not fully accepted. According to the hypotheses of the new theory, decision makers, through the power of political proposals, play a strategic role in economic development, compared to a government oriented towards populist decision-making due to increased expenditures and decreased fiscal pressure (Peacok and Wiseman, 1961, p. Xxvii). There are still differences over the limits of government expenditures and revenue and how they can work in the process of economic recovery or development. Brennan and Buchanan in 1980 lay the groundwork for a new theory in which government is viewed from a different perspective, in which it seeks only to maximize public revenue (p. 5). The question behind the book they wrote, *The Power of Tax*, is about the possibility of limiting the government's taxing power. According to the Leviathan hypothesis, as long as the government imposes various taxes and fees that create a high tax burden, there should also be constitutional regulations that have the power to limit the government in terms of tax and expenditures excesses.

4. Classical economic theory

The classical economic theory is based on hypotheses with orientations towards a wide spectrum, launched in the economics schools of the XVIII and XIX centuries. Specifically, the term classical economics was developed with the advent of Western capitalism. The latter is a widespread expression in Western Europe that defines the detachment from European feudalism and the entry of Western Europe into a stage in which production is controlled by private entities. However, the Scottish economist Adam Smith is considered by academics to be the progenitor of this theory. In his book, *The Wealth of Nations*, from 1776 he lays the theoretical foundations of classical economics. Although the theories developed by different classical economic thinkers did not have a unitary perspective on the evolution of society and the economy, there was a tendency to encourage the free market in which important decisions are made by the business environment ensuring full use of economic resources.

The decline of classical economics began with the publication of Capital by the philosopher in economics and politics Karl Marx in 1867.

Marxist economics changed perceptions of classical economics, although it made very few contributions to economic theory.

5. Keynesian theory and tax multipliers

Keynesian theory came up with assumptions that contradicted the hypotheses of classical economists and theorists. The name of the theory is given by its initiator, the British economist John Maynard Keynes. The ideas promoted had a major impact even in the application of modern fiscal policies, while also influencing the way governments act on their implications for economic recovery. In his work A Tract on Monetary Reform, Keynes (1923, p. 80) disapproved of classical economists' ideas of emphasizing long-term economic prospects that “this long-term is a misleading guide to day-to-day business.

In the long run, we are all dead. "Although after the great economic crisis of 1930, classical theorists were against government intervention in the recovery of the economy, Keynes argues the opposite. Government intervention in times of short-term recession is the best treatment. This intervention is given by the increase in government expenditures and not by the growth of savings, as expenditures will encourage production and, as a chain reaction, more jobs will be created. These actions are known as tax multipliers, which create a causal relationship between rising government expenditures and economic growth. Although the phrase tax multiplier has been attributed to Keynes, it was theoretically substantiated by his student, Kahn (1931, p. 181), in The Relation of Home Investment to Unemployment, stating that in the event of increased expenditures government production will increase in the same direction. The position of tax multipliers was later outlined by Keynes in his 1933 papers, A Monetary Theory of Production and 1936, The General Theory of Employment, Interest and Money. Thus, Keynes explicitly defined the investment multiplier. "When there is an increase in aggregate investment, income will increase by an amount k that is twice the investment" (Keynes, 1936, p. 61). Thus, the expenditures on public investments made received a special importance in the Keynesian literature.
If the tax multiplier has a value greater than one, then a one percent increase in government expenditures will result in a one percent increase in output. In this context, Keynes categorizes government expenditures as an exogenous variable whose role is crucial in economic growth due to its multiplier effect. In the short term, they can help to balance the economy, but in the long run

they can generate inflation if prudential limits are exceeded, but they can also lead to an increase in the unemployment rate if they are not used to stimulate production.

6. The new Keynesian theory

Around the 1970's a new Keynesian theory emerged that succeeded in detaching the process of economic development from the classical Keynesian theory. Proponents of this theory include Fischer (1977) and Phelps and Taylor (1977), who did not consider Keynesian theoretical foundations adequate to provide sound insights into the possibility that a number of tools could be used to implement a fiscal recovery policy or economic development. The British economist's ideas originated from hypotheses about the economic effects of the Great Depression around the 1930s, according to which rising government expenditures and declining revenues could stimulate the economy in recession. In contrast, the proponents of the new Keynesian theory argue that an expansionary fiscal policy would not encourage production or economic growth, the argument being made in view of the deficit caused by excessive government expenditures that would encourage saving. The benefits of government involvement in the process of balancing and developing the economy through fiscal policies remain in this case a questionable and uncertain segment. Moreover, the period of stagflation in the 1970's, characterized by the combination of slow economic growth and high inflation rates, is a reference point in changing the economic ideologies known and accepted until then.

7. The new classical economic theory

The foundations of the new classical economic theory are found in Walrasian hypotheses. The latter were developed by the French economist and mathematician Léon Walras who created the modern theory of general economic equilibrium. These ideas are identified in his famous work *Elements of Pure Economics* which promotes the principle that the existence of excess supply in one market must be congruent with the excess demand in another market in order to create a balance. This developed theory is called Walras' Law. Along with him, Willian Jevons through The Theory of Political Economy and Carl Menge through *Principles of Economics* contributed to the creation of the new current of classical economics. The finalization of the principles of the new classical economic theory took place after the 1970s when the failure of the new Keynesian theory to explain and eliminate the effects of stagflation was demonstrated. Thus, keeping elements of classical economic theory and eliminating existing Keynesian principles, the new current gradually became a new distinct classical economic theory.

However, the new classical economists offer a number of reasons for the inefficiency of fiscal policy. These include rational expectations, as the citizens of a state are future-oriented, taking into account how the country's budget is managed. This is where the impact of government expenditures on personal budget comes into play. The tendency of citizens will be to save when the government spends excessively, as the rationale is to finance them by raising taxes. In short, government expenditures will be borne by citizens through mandatory levies. Another explanation for the inefficiency of fiscal policy is the mutual nullification of the effects of macroeconomic elements.

8. The theory of the real business cycle

In his 1973 article *Some International Evidence on Output-Inflation Tradeoffs*, Robert Lucas laid the foundations for a new theory in economics, called the real business cycle. The ideas of this current are based on the analysis of 18 countries by compromising inflation and real gross domestic product. This theory of the real business cycle is an extension of the new classical economic theory in which "observations on the quantity of aggregate prices are seen as intersections of aggregate demand and aggregate supply" (Lucas, 1973, p. 326). Moreover, this theory is based on the hypothesis that the fluctuations of the real business cycle are given by technological shocks or variations in production. The latter, in turn, is influenced by the level of aggregate demand and supply. In short, the two macroeconomic factors mentioned are responsible for the changes and shocks produced in the economic cycle.

9. Conclusions

The main objective of this study was to identify the theories underlying the application of fiscal policies. Going through the theoretical aspects related to fiscal policy and government expenditures has facilitated the indexation of the notions needed to understand the issues related to this research niche. Following the review of the above economic theories, it can be stated that they all aim at the optimal use of government expenditures to maximize economic and social welfare. Wagner's law remained a point of reference in the development of subsequent theories, models and hypotheses, as the increase in investment expenditure will stimulate the increase in production and, implicitly, the increase in gross domestic product. Such a tax action must be imposed by the government and not by public authorities in a particular jurisdiction or region as argued in the Leviathan hypothesis. This will avoid the risk of fiscal inequality and uneven economic development. According to classical economic theory, in the absence of fiscal policies to limit public expenditures, their growth inevitably leads to the degradation of a state's economy, affecting future generations due to irresponsible consumption-oriented behavior, giving rise to the tax burden. The annihilation of these effects is possible through an awareness of the fact that the increase in public expenditures causes a time lag, so current expenditures will impose costs for the future.

Keynesian theory has positive and realistic valences only in the short-term economic recovery. This starts from the assumption that an increase in public expenditures to cover the deficit, followed by the issuance of currency will have the effect of economic recovery, without leading to inflation. Their incidence on gross domestic product is higher than in the case of taxes, because it affects first the income and only then the level of production. Future generations will not be affected, as the state will replace public expenditures with private expenditures, thus making it possible to anticipate tax increases. Neo-Keynesian theory is based on Keynesian doctrine, although it points to a number of its deficient elements. The hypotheses of the neo-Keynesian theory are similar to those of the new classical economy because they try to maximize the efficiency of decision-making regarding public expenditures, with rational expectations. The results revealed that economic theories will remain only a foundation in the application of fiscal policies, and the most important aspect in terms of identifying economic reality is given by his in-depth study.

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