

## THE GOALS OF FISCAL POLICY

Orhan ŞENER

Government role as an economic agent is becoming a very important issue all over the world. Although, the western countries are market oriented, the private sector activities are heavily influenced by the decisions taken by the government. Besides that, many imperfections that exist in market economies lead to inefficiencies calling for governmental intervention and refutation. As a result of these developments, more than %40 of the national income is controlled by the public sector in developed countries, but this ratio is less than %25 in developing countries. Owing to the steady growth of public sector, the scope of public economy and public finance is becoming very broad, to include a wide variety of functions.

Governmental sector not only provides public goods and services such as national defense, internal security, general health and education, justice, etc., but also concerns with poverty, hunger, sustaining minimum level of consumption. Government produces and sells private goods and services; copes with the pollutants and nuclear radiation; regulates monopolies and industries and money supply. These are done by the government to improve the well functioning of market mechanism.

On the other hand, a wide variety of taxes imposed on the people and the goods or services may encourage or discourage private savings and investments; the incidence of taxes may distort the income distribution; and their revenue yield may also differ from each other. Thus, budgetary decisions or fiscal policy may affect the economy positively or negatively. For this reason, a proper fiscal policy should be designed in line with the three main goals of the economy that are resource allocation, income distribution and stabilization.

### A. RESOURCE ALLOCATION

The inverse relationship between the unlimited scope of human wants and the limited resources such as land, labor and capital calls for efficient resource allocation. The resource allocation goal of the society involves the satisfaction of public and private wants by the goods. Market mechanism or private sector is designated to produce private goods and services such as defense and other indivisible services.

There are also other institutions such as voluntary associations satisfying non economic needs as religious services. In the secular western countries, religious services are provided by the churches independent of governmental provision. Thus, religious services are financed through the voluntary contributions by the members of the churches. But, in Turkey religious services are being provided by the public sector under the Presidency of Religious Affairs, whose budget exceeds the total of more than six ministries. This misallocation problem, that is the violation of efficient resource allocation, has been discussed by the public opinion with respect to freedom of religion.

Governmental or budgetary resource allocation function also involves the public sector intervention with the private sector and regulation of the monopolies and market mechanism. On the other hand, to satisfy public or collective wants government also provides public goods and services by its state economic enterprises and public utilities. In addition to that, government sometimes buys private goods and services from the private firms and provides for the citizens. All these economic activities contributes to the increasing role of governmental resource allocation function. But, due to many imperfections both in public and private sectors, actual resource allocation may diverge from the optimal resource allocation.

#### a) Optimal Resource Allocation

The optimal resource allocation can be explained by employing the production possibility curve and the social indifference curves<sup>1</sup>

The social production curve (pp) or production possibility curve, relates the marginal rates of transformation between the production of public and private goods. Of course, the higher the position of the (pp) curve, the greater the production level of a society. Since the shape of the (pp) curve is concave to origin, resources can not be substituted with equal efficiency between the production of public and private goods. Thus, reallocation of resources from (a) to (b) would add more in private good production (q1q2), than is sacrificed in the production of these goods production (y1y2). Decreasing returns to scale in the production of these goods result in unequal trade off between the production of public and private goods output. This is due to fact that, some public goods such as national

<sup>1</sup> Herber, Bernard: *Kodern Public Finace*, Irwin, Illinois, fifth ed., 1983, p 13

defense or security services are produced more efficiently with less input costs per unit of production, by public sector than the private sector. Because, when many goods are produced by one sector, then principles of diminishing returns (or decreasing returns to scale) comes in to operation, resulting in increasing cost of production. Thus, the nature of the good concerned and the law of diminishing returns causes an unequal trade off between the outputs of public and private sectors.

On the other hand, each indifference curve ( $s_0, s_1, s_2$ , etc.) relates the marginal rate of substitution between private and public goods consumption by society. The high level of social indifference curves provides greater amount of consumption, hence higher level of welfare compared to a low level of indifference curve. The shape of any social indifference curve is determined by the level of purchasing power of the individuals in market and the political representation in public sector. They also represent effective demand for public and private goods. Of course, the higher the social indifference curve the greater the level of social welfare, that it represents. The convex shape of

get a smaller quantity of private goods at the upper part of the social indifference curves, and vice versa on the lower part of the same curve. The law of declining marginal rate of substitution comes into operation at the upper and lower part of the social indifference curves, by these reasons. First, as private goods at the upper part of the curve become scarce, the greater is the tendency for its relative substitution value to public goods to increase and vice versa. Secondly, if one of the sectors dominates the economy, then important economic and political distortions are likely to occur. For instance, an extreme degree of government resource allocation leads to loose of political freedom, whereas extreme private sector resource allocation leads to loose of significant economic freedom or to the state of anarchy in the society. On the other hand, the over consumption of private goods compared to public goods gives rise to lack of law and order or insecurity in the society.

Optimal social resource allocation (or social balance) is reached in the Figure 1.1, as shown by point (e), where the production possibility curve and the social indifference

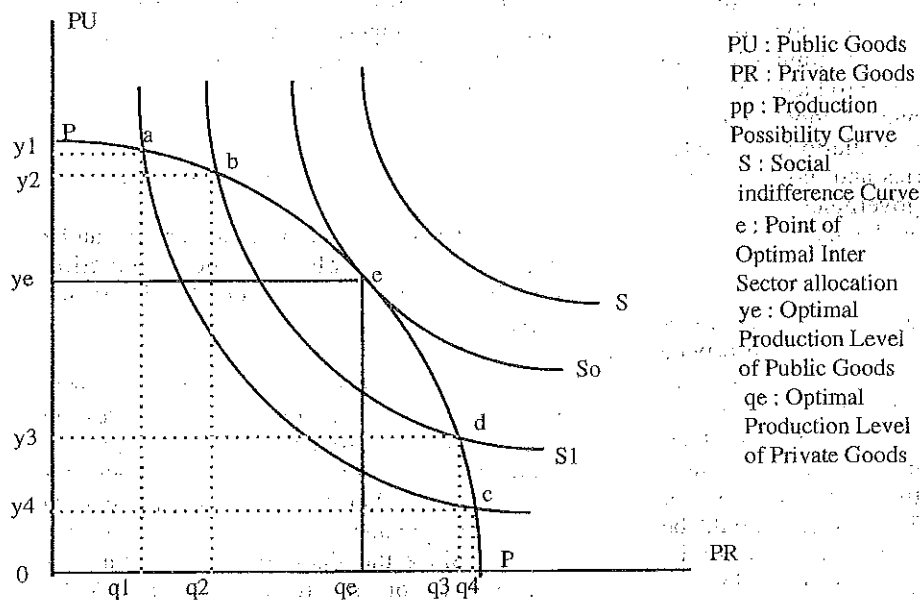


Figure 1.1: Optimal Resource Allocation

social indifference curves reflect the diminishing marginal rate of substitution between public and private goods in providing a constant level of social welfare. Due to declining marginal rate of substitution, society is willing to give up more than proportionate amount of public goods to

curve ( $s_0$ ) have the same slope at point (e), it shows the best obtainable welfare level. At this welfare maximizing point,  $q_e$  is the amount of private goods and  $y_e$  is the public goods produced. This equilibrium point (e) satisfies Pareto efficiency condition that is: The marginal

rate of transformation in the production of public and private goods is equal to the marginal rate of substitution by the society in the consumption of public and private goods.

Optimal social resource allocation may deviate from actual social resource allocation due to unfair income distribution and imperfections in market and distortions in political decision making in public sector. Unfair income distribution and inefficient political decision making process don't allow the consumers to reveal their preferences to private and public goods.

#### **b) Misallocation in the Economy**

Market oriented economies tend to over allocate the resources to the private sector, whereas socialist countries to the public sector, whereas socialist countries to the public sector. As expressed by Galbraith, over allocation to one sector causes social imbalance or sub optimal resource allocation problem. However, many developed countries are trying to attain the optimal social allocation point or mix, within the context of mixed economy philosophy. For instance, Scandinavian countries have already reached to optimal social resource allocation mix, compared to the European countries and to the United States. However, resource allocation is better in the European countries than the USA, because higher education, health care, housing and other social services are more socialized in these states. Besides that, governments in the European countries produce private type goods with its state economic enterprises, many regulated enterprises are established as public utilities. Public utilities producing electricity, gas, communication etc. are owned by both government and private firms in the USA. However, Clinton administration is likely to reallocate sources from private sector to government sector in order to attain social balance, which was ignored by the Republicans.

As argued by J.K. Galbraith, when the resources are misallocated between the public and private sectors, it is said that sub optimal allocation or social imbalance exists in the economy. The term social imbalance is used to refer to over consumption of luxury goods such as cars and color TV's at the expense of under consumption of public goods such as health, education, transportation etc. Of course, resources are much more misallocated in developing countries than developed ones. For instance, there are many cases which causes misallocation or social imbalance problem in Turkey. Some of them are as follows:

1) Government is producing many types of private goods with the state economic enterprises, that it's not supposed to produce.

2) But is not providing public goods and services at appropriate level. Because, budget deficits of state economic enterprises are being covered by the general budget of the state.

3) Government is also providing some services, which is not public goods such as religious services by Religious Affairs.

4) Heavy burden of foreign debts.

As a result of these reasons, government is not able to use sufficient revenues in providing public goods and services. For instance, the budget of Religious Affairs is greater than the total of six ministries. As a matter of fact that, religious services are provided by the voluntary associations or churches in developed and secular countries. The huge amount of interest payments on debts also reduces the availability of the public funds that will be spent on producing public goods and services. Owing to the new liberalization policy, started by Özal's government in 1980, the foreign debt stock was increased from 13.6 billion dollar to 56 billion dollars at the end of 1980's. Thus, ratio of foreign borrowing requirements to budget revenues has been increased from 3 percent in 1980 to 17 percent in 1990's. as a result of this developments, interest paid on debts constituted the highest item in public expenditures, resulting in less funds to be allocated to public goods and services.

Misallocation of resources also causes significant in efficiency distortions in the economy. For instance, about 90 percent of the transportation services are carried out by private firms in Turkey. Heavy reliance on private transportation is much more higher than public or mass transportation. Besides that, the social costs of the private transportation in the form of increasing traffic accidents, loss of lives (more than 7.000 people a year), oil consumption, pollution in the big cities etc., reduces the level of social welfare. Thus, misallocation off the resources increases the cost of production and reduces the competitiveness of the goods and services in international trade.

#### **B. INCOME DISTRIBUTION**

Distribution function of budget policy concerns with the distribution of national income and the wealth among the population in the private sector and the political voting influence in public sector. Market economy

tends to satisfy the pecuniary demands, that are related to the dollar votes of the individuals. But, this causes to inequality in consumption of all goods produced by the private sector. The inequality in distribution of income and wealth produced in the market economy adversely affects the efficient resource allocation. As a result of this, individuals who don't have purchasing power are not able to reveal their preferences to private goods. Besides that, high income groups organized in the form of big business associations, interest and pressure groups and lobbies can easily affect the governments to produce public good and services on behalf of themselves. For instance, car producing firms can easily affect the government to construct new highways. Unless a proper state of income distribution is secured, market mechanism will not meet the demand of low income groups. Then the resources will be reallocated to produce the foods and services that are mainly consumed by high income groups. Thus, necessity goods and services will not be produced and the welfare level of the society will be reduced.

#### a) Income Determination

Economists set the criteria for income distribution with respect to factor pricing, and distribution of national income among land, labor and capital. For efficient resource allocation, the marginal values of factor products should equal to in all uses. But, efficient factor pricing according to resource allocation may not prevail in the market economies.

Labor (earned) income is determined by the distribution of abilities, which is also determined by the educational opportunities. This means that, unless proper educational opportunities are given to low income people, the share of their income will decline. Capital (unearned) income is determined by the distribution of wealth as determined by inheritance, lifetime savings and marriage patterns.

In an competitive market, when the distribution of endowments are given, the distribution of income depends on factor prices, and these prices are equal the value of the marginal product of the factors. But, in an competitive markets factor prices are not determined by the value of marginal product of the factors, only. They are mainly determined by social factors such as salary structure, social status, race, sex and marriage patterns, and bequests and taxation etc. Due to these factors, there has always been inequity or unfair income distribution problems in many societies. Unfair

income distribution problem is very serious in developing countries comparing to developed countries.

#### b) Redistributive Policies

Due to imperfections in the markets, marked determined income distribution is not regarded a fair one. On the other hand, Pareto formulation of income distribution that is, "someone gains while someone else losses" and social welfare function in which social weights are given to gains by some one and losses by others helps a little. Thus, economic criteria determined by market mechanism with regard to income distribution is not excepted by the societies, in the application of economic and fiscal policies. Because, recent decades have witnessed a growing tendency for distribution inequality to increase, especially in developing countries. For instance, the top quintile (or %20) of households are estimated do own %60 of national income and the wealth, whereas the lowest %40 owns only the 9.6 percent in Turkey. In addition to that, the new economic policy started by Özal's government in 1980's reduced the real income of wage and salary owners about %50 in favor of high income families.

Policy measures such as public expenditures, tax, and transfer programs; international trade, anti inflationary and antitrust policies affect the state of income distribution. In addition to this programs and policy measures regional development programs, price support policies and regulated prices will also affect the economic welfare and hence the distribution of income.

Economists are likely to apply two equity concepts to improve distribution, namely vertical equity and horizontal equity. Vertical equity implies that individuals and families in different circumstances should be treated differently in paying taxes and receiving different consumption subsidies. For instance, a bachelor pays higher taxes than a family unit of five living on the same income and receives less subsidies than the same family. Horizontal equity means that individuals or families in similar circumstances should be treated similarly with respect to taxation and the availability of the public subsidies, for particular kinds of consumption. For instance, two families with equal and similar age distribution pay the same taxes and receives the same subsidies.

Redistributive programs would be designed in the form of different tax, transfer and public expenditure schemes, or combining forms also possible. Progressive income

taxation, in which the ration of tax to income increases with income level, is generally used to improve the income distribution. In order to improve the income distribution in favor of low income families, a tax-transfer scheme combining progressive taxation of high income with a subsidy to poor. But, this policy measure will not be efficient, unless progressive taxes are used to finance those services such as health, education, housing and transportation and etc., which particularly benefit low income families. These distributive policies should also be supported by another policy that includes an excise taxes imposed on the goods consumed by high income classes subsidies to the goods and services used by low income classes. As will be discussed later, each policy alternative has different impact on the consumption and production choices in the economy.

The budget policies and its incidence affects the state of income distribution to a large extent. For instance, tax policies favoring to capital income and discriminating against to earned income adversely affected the state of income distribution in Turkey in 1980s. As a result of huge amount of tax incentives given to capital incomes, the share of earned incomes (wages and salaries) in national income dropped from 32 percent in 1979 to 18 percent in 1988. Whereas, the share of capital incomes (rent, interest and profits) in national income rose from 68 percent to 82 percent in the respective years<sup>1</sup>

### C. STABILIZATION

The stabilization goal of the public economy is concerned with coping with unemployment of the factor of production, maintaining stable prices, the balance of payments and an acceptable rate of economic growth.

It has been argued that, a large private sector may easily leads the economy to instability<sup>2</sup>. Increasing population, rapid technological changes, increase in money supply, state of war, optimism and pessimism prevailing in a society are the other important causes of fluctuations in employment rate and price level stability<sup>3</sup>. The USA economy always witnessed a lot of depressions in its economic history. The experience of Great Depression

changed the People's mind on the role of governments stabilization function. Thus, assuring full employment and price level stability was considered as a public responsibility.

Most of the stabilization policies rest on Keynesian thoughts. He argued that, deficit spending with public expenditures exceeding tax revenues, could stimulate the economy to reach the full employment level, during the depression periods. He also argued that, a fiscal surplus with the tax revenues exceeding public expenditures, would prevent inflationary process especially during the boom phase of the business cycles<sup>4</sup>. Keynesian deficit budget polices were successfully applied in the USA and in many countries.

In 1950s economists believed that the problem of instability could be easily fine tuned and they also claimed that, fiscal dividends generated by a progressive taxation would be distributed, during the recession period, to increase aggregate demand.

But, in 1970s Vietnam War, high level of public borrowing and money supply, and oil crises produced a slow economic growth leading stagflation. Stagflation is the simultaneous existence of High employment along with high level of inflation. In this decade economists claimed that, Keynesian policy instruments such as deficit budget and surplus budget policies are no longer efficient to cope with inflation and unemployment problems. Instead, they suggested various income policies such, as wage price guidelines, wage-price controls and tax induced policies to cope with stagflation. They also supported balanced budget as a precondition to stabilization. These economists argued that increase on the money supply should be equal to the increase in the national income.

In 1980s, Reaganomics based on Friedmanism supported the idea of the least governmental influence on stabilization and resource allocation. Their ideas gave rise to market dominated stabilization policies and then privatization policies and then privatization process has been started in England and in many developing countries. Although, inflation rate has been reduced as a result of privatization process, but at the expense of high level (about %10 at the end of 1980s) unemployment. Moreover, the outcome of Reaganomics became questionable. And the new administration of the Democrats in the USA, are likely to reconsider

<sup>1</sup> Source: State Statistics Institute, 1973, 1985, 1989, 1990.

<sup>2</sup> ARONSON, J. Richard: Public Finance, Mc Graw Hill, Newyork, 1985, p.20

<sup>3</sup> HERBER, P. Bernard: Modern Public Finance, Irwin, 1983, p.5

<sup>4</sup> KEYNES, J. Maynard: The General The ory of Employment, Interest and Prices; Harcourt, Brace, New York, 1936

Keynesian policies in 1993 to solve the stagflation.

Whatever the different public policies have been applied in the past, the role of government in the stabilization usefully accepted. As a matter of fact that, a greater public sector to cope with instability is also welcomed by the most of the European countries.

### a) Stabilization Policies

Stabilization policy is usually administered through fiscal and monetary means. Tax rates, public expenditures and public borrowings as a means of deficit and surplus budget policies are widely used as fiscal policy. When the aggregate demand is insufficient to restore stability, expansionary policies are administered through decreased tax rates, increased public expenditures and interest paid on public debts. If the aggregate demand is higher than total output level, then restrictive fiscal policy measures through tax increases, reduced level of public expenditures and increased public debts are employed. Thus, the government could attain its stabilization goal of full employment consistent rate of price level, by altering its budget deficit and surplus to compensate for the deficiency or excess in private aggregate demand. Moreover, as it is referred to built in flexibility, progressive income tax structure may be designed in such a way so that it restores stability automatically.

Monetary policy measures such as reserve requirements, discount rates and open market operations may also help to restore stability, provided that they are well administrated. Monetary policy measures expands the money supply to increase liquidity, reduce interest rates in order to increase aggregate demand. Whereas, restrictive monetary policy instruments reduces the aggregate demand by decreasing liquidity, increasing interest rates and thereby decreasing the money supply. Due to many imperfections in market economy, monetary policies employed to restore stability are not that efficient compared to fiscal policy.

In addition to these fiscal and monetary policies, governments may also employ some direct control measures to restore stabilization, as it was used in the form of wage and price freezing policies in 1970s in the USA.

### b) International Comparisons

A breakdown of stabilization function as to its subgoals is show in the Table for some selected OECD and EC countries.

Country	inflation rate	unemployment rate	foreign trade(X) balance	growth rate
Austria	3.1	3.8	-0.8	2.6
Belgium	3.3	9.7	6.4	2.0
Canada	2.9	10.2	-18.0	4.1
Denmark	2.7	10.2	2.6	2.5
France	2.7	10.1	-7.0	2.7
Finland	0.3	9.8	-4.2	-0.4
Germany	4.0	5.0	-14.0	2.5
Greece	14.7	9.6	-2.0	1.3
Italy	5.4	10.8	-17.0	2.5
Japan	2.1	2.3	82.0	3.5
Netherlands	3.4	6.4	13.1	1.8
Norway	3.0	5.1	6.1	2.0
Portugal	11.4	4.5	-1.6	2.6
Spain	5.6	15.2	-16.6	2.9
Sweden	3.5	4.1	-4.1	0.2
Swiss	4.5	1.6	11.8	1.2
Turkey	70.0	13.2		2.8
USA	3.6	6.7	-56.0	3.8
UK	4.1	9.9	-15.0	3.2

**Table:** The subgoals of stabilization functions in some selected countries

The table shows that most of the industrialized countries are not experiencing stagflation any more, at the beginning of 1990s, as opposed to 1970s and 1980s. However, stagflation problem in the form of very high unemployment and inflationary rate has existed for the last decade. As long as the 3 percent inflationary rate is acceptable for the economic grounds, the Western countries are not facing to serious price increase problems for the time being. But, in Spain, Turkey, Italy, Canada, Denmark France, Finland, Greece and UK the very high level of unemployment is becoming a serious social problems. Besides that, some of these countries such as Turkey, Portugal and Greece are also experiencing high level of inflationary problems.

### c) Stabilization in Turkey

As it is shown by the above examples, in evaluating any public expenditure program, its possible affects on allocation, income distribution and stabilization functions of the public economy should be considered. The interrelated nests and the conflicts among the main and sub functions were not designed

<sup>x</sup> Billion dollars

properly in 1980s. For instance, Özal's government gave the first priority to realize only one sub function, which was equilibrium in foreign payments, and neglected other major and sub functions. In order to encourage exportation substantial tax incentives and exemptions were provided. Although, exportation was increased, but importation was higher than exports, causing deficit in balance of payments. In this period, government tripled external borrowing, but couldn't restore the equilibrium ..?. in foreign trade. Since, the producers were not provided sufficient incentives, the rate of economic growth was adversely effected, due to export led policies. Thus, all the major functions and the sub goals of public economy were heavily distorted. As it is shown by the statistics below unemployment and inflationary rates increased, and the economic growth rate reduced, and the gap between exportation and importation was widened<sup>5</sup>.

**Unemployment:** The rate of unemployment was 5.7 percent before 1980, but it increased to some 16 percents in 1980s.

**Inflation:** The annual averages of the rate of inflation were as follows in different periods:

- During the First Five Year of Development Plan (1963-68) %5.2 Second Five Year period (1968-72), %11.2; Third Five Year Period, %21.6;
- In 1980s, it was %50-70.

**Growth rate:** The annual economic growth rates in different periods of five year plan implementations and after the year 1980 are as follows:

<u>Periods</u>	<u>Growth rate</u>
1963-1698	%6.6
1968-1972	%7.1
1972-1979	%6.4
1980-1990	%4.4

**Balances of Payments Equilibrium:** The deficits in balance of payments in different periods are as follows:

<u>Years</u>	<u>Balance of Payments</u>
1988	-2.7 Billion dollars
1990	-9.6 Billion dollars
1991	-7.3 Billion dollars
1992 (estimated)	-8.0 Billion dollars

## D.INTERRELATEDNESS AND CONFLICTS AMONG THE FUNCTIONS

No government stabilization policy can be neutral with respect to allocation and distribution function of the public economy. On the other hand, most of the distribution policies alter the patterns of factor ownership, thus affect resource allocation and stabilization functions. A reallocation of the resources from private sector to public sector, we can say that there is always inter relatedness and conflates among the functions of public economy. This can be clarified by the following examples.

- Government may want to secure a more fair income distribution through progressive income taxation to finance the transfer payments to low income families. But, this redistributive policy is likely to interfere allocation function.

- When the government increases public expenditures on educational services, which is mainly allocation function. This allocation of the resources to education will confer a distributional benefit on the students, whose future income rise the most. This allocation will also affect the stabilization function. Because, financing educational services may call for taxes or public debts, that will cause further adjustments in aggregate demand.

- Suppose that government increases the income level of low income families through transfer payment. Since the marginal propensity to consume is too high in this group, distributional policy will increase the aggregate demand and the price levels.

- Depending on the type of the taxes which is used to finance the public expenditures, some taxpayers will prefer leisure. The high tendency of leisure preference will reduce the output level, leading to stabilization problems.

<sup>5</sup> State Planning Organisation