The efficiency of the fiscal policy in some concrete doctrinal framework

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Abstract: This paper mainly aims to clarify the ways in which fiscal policy measures can influence the economy, with reference to two popular theories: rational expectation and public choice. These theories present particular issues, born on the Keynesian theory background and explain the cause and effect relationship characteristic of public decisions.

Keywords: fiscal policy, rational expectation, public choice

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1 Introduction

The economic doctrine requires a contextual framework with specific implications for the nature of fiscal and budgetary decisions. This paper deals with two specific positions of economic theory, namely: the theory of rational expectations and the public choice theory.

2 Fiscal policy in a rational expectation framework

John Muth (1961) first developed the theory of rational expectations regarding the insurance and goods markets. He started from the assumption that expectations, being inspired forecasts of future events, are essentially similar expectations that economic theory gives to the events. From the perspective of professional economists, still dominated by Keynesian macroeconomic thought, its contribution was found to be premature. He had to wait until the microeconomic foundation of macroeconomics, especially the Phillips curve reformulation of Friedman in 1968, paved the way for the effective conduct of his theory. Since the original formulation of Muth, it had to drain a decade for the notion of rational expectations to be accepted by economists. Drawn from the monetary current, new economic theory of rational expectations considered that the Keynesian macroeconomic models can not be a reliable guide for formulating fiscal policy, monetary policy and other policy categories.

Neoclassical economic theory is based on two postulates: a) prices and wages are flexible and have the ability to adapt quickly to changes, b) people know and use all information and the economic theories on which are based the economic policy measures, so that they can make economic decisions fully informed and able to properly weigh the consequences of measures taken by the stat. In 1972 Robert Lucas became a pioneer on the use of rational expectations in the macroeconomic theory in a framework that today is known as the "new classical school". In 1973

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Thomas Sargent strengthened Lucas's original vision. Reduced to its essentials, Muth’s hypothesis says, basically, that there is a relevant economic theory and the predictions derived from this theory are the best as possible. Expectations are rational when they coincide with the forecasts derived from the relevant economic theory.

Lucas and Sargent approached the economy as one in which all maximizes the rational expectations utility. Rational agents take into account any information they have at some point, but not only information about the past. In particular, if the government announced an economic policy, the agents take account of it immediately. If the measures announced are able to change prices, wages, interest rates, then individuals will not expect to actually find these changes to integrate them into their economic calculations. Rational expectations theory adds additional hypothesis: agents know the economy functioning. They thus provide the correct economic policy effects; they do not commit systematic errors in their predictions. The only possible errors are due entirely to the unpredictable events for all businesses. But these random errors are perfectly corrected immediately. If expectations are rational, gradual adjustment process described as in the monetarist logic is off. If prices fall, employees immediately and correctly anticipate ongoing deflation. Employers know that their workers correctly anticipate lower prices and they may, therefore, to propose an immediate reduction in nominal wages, commensurate with that of prices, to keep jobs and production. It is useless to expect the appearance of unemployment to make the workers to accept wage reductions, which then allow reducing the prices enough to spread production. If expectations are rational, the supply curve is vertical, on short and long term. The economy runs continuously according to the classical logic. Of course, in this perspective, economic policy has no utility, even in the short term. Since all agents access the same information, as policy makers, they say, they respond to the systematic policy initiatives, neutralizing them. Of course, mistakes are possible, since the caution is not perfect, in a world where the economy is always vulnerable to random shocks. In these circumstances, money is not neutral in the short term, although agents learn quickly and neutralize any attempt of the government to exploit the situation.

According to this theory, fiscal policy does not exercise direct impact on the balance of the production or employment, but only on price. Of course, the changes in government spending, taxes, or both, may influence the equilibrium level of real product through microeconomic effects of "supply-side". Assuming that these neoclassical economic conditions do not apply and fiscal policy could have some impact on the real economy, Lucas's criticism suggests that policy makers would be extremely unintelligent if it were based on estimated economic models to determine appropriate fiscal measure in an economic downturn. In the presence of rational expectations, real variables (such as relative prices, unemployment and real output) are independent of changes that occur in the anticipated monetary and fiscal budget. In a broader sense, rational expectations hypothesis can be seen as an implication of the basic assumption of the economy that agents optimize their actions given the restrictions of the economic environment. Any other behavior would be under the optimal level.

Keynesian and neoclassical models have been hit by the rational expectations revolution. There is no Keynesian type role in the economies in which only unanticipated demand and supply shocks can have real impact and stabilization policies are anticipated. However, many economists were Keynesians regrouped behind a standard of "New Keynesian", incorporating the assumption of rational expectations, but rejecting the full information. From this perspective, neo-Keynesian models support the restoration of basic Keynesian doctrine, namely that supply and demand shocks are able to induce persistent economic crises and monetary and fiscal budgetary tools are capable of stabilizing the macroeconomics.

3 Public choice theory

A century and a half before the Great Depression the U.S. and UK governments did not accept budget deficits (only in case of war or economic recession). Even regular deficits were viewed with suspicion and concern. In years of peace and economic boom, budget surpluses were used to cover debts made during wars or recessions. But previous rules had reformulated in 1930.

The public choice approach was developed largely by the Virginia School. This provides the essence of a theory of political market failure (political space is identified with a market), who comes to outweigh the private market failure theory advanced in the first period after the war as "new welfare economics". From this perspective, rational individuals accessing political markets to maximize expected utility. Political market analysis or the "public choice school" has as a starting point the publication, in 1962, of "Calculus of Consent" by J.M. Buchanan and G. Tullock. Tullock defines "public choice" as an "application of economic method (monopoly, competition, information costs) to political and bureaucratic behavior" (Tullock, 1978). This school has an interest to criticize in a proper manner, as a means of disclosing market preferences, characterizing as logrolling (political exchange services), concerned with investigating corruption and business.

Most times, political markets are perceived as agencies of wealth transfer to some net cost to society as a whole. Rarely happens to correct and, even then, occur unexpected social costs of interventions to improve wealth. The Virginia school do not sees political market equilibrium sharing efficiency characteristics described by the theory of general equilibrium with private competitive markets. Beyond this historical location, many authors apply economic calculation in politics, for example, considering that the politician maximizes his own utility function (Becker, 1958) and, more generally, that political space is identified by a market (Breton, 1974) with supply and demand of social protection.

This theory, often called "the economics of the politics" based on the assumption that the politician, as well as economic man is a rational being, which pursues its own interests. The state, say the founders of public choice theory, is not a building equipped with the gift of infallibility, but a "human organization", where decisions are taken by politicians and officials who are susceptible to their personal interests and they can deceive. Thus, politicians are concerned about being elected or reelected, and officials have the ambition to increase power and remuneration, to ascend in rank and maximize the funds they manage.

Public choice is not limited however, to a critical discourse on the state, but is a research of the voting rules and optimal setting. Public choice theory provides an economic model of political decision making processes, using microeconomic theory of voter behavior with reference to the rational voter model. Decision obtained by ballot is supposed to reflect the utility.

Basically, voters who want to maximize their expected utility can choose to remain ignorant about the competition policies among political parties because their individual votes are seen as lacking influence in the political outcome, which has several consequences. First, politicians who want to maximize the number of the votes they expect, contrary to the theory of Anthony Downs (1957), can enjoy some discretion in such a way as to avoid what the median voter dictates. Second, once the political influence of the median voter's was reduced, they develop market opportunities for political interest groups to distort political outcomes to the possible average. These interest groups gaining support from politicians using the money saved to finance future election campaigns. Third, since interest groups operate more effectively in the political opaque environment, they are oriented counter-service rather than money transfer mechanisms, infusing marshallian costs (dead weght) on society. Fourth, because their lobby rarely bears the costs to politicians, interest groups seeking greater rent seeking [rent seeking theory belongs to the school of Virginia, - first time in an article by Gordon Tullock in 1967, about the costs involved in monopoly, which he considers undervalued, because it includes the resources consumed obtaining the monopoly situation. The term was first used by Anne Kreuger in 1974, to refer to the profits from the restrictions imposed by government activity. Rent-seeking is a competition to obtain additional benefits that are not made on the market, but with special privileges] costs on society mainly in exchange for free of wealth transfers from others in society to some of theirs.

Attracting the median (neutral) voters represents often the key to electoral success. Median voter theorem thus gets. This very important theorem expresses a trend of voters was coming closer to the median voter located in a position where there are an equal number of people right and left. Median voter theorem was applied to explain the types of public expenditures and provides the basis for the law's direction, which shows that income redistribution by the government tends to favor middle-income groups. In general voters will vote for a level of public expenditure or allocation of public goods for which utility is maximized. On the other hand, policy analysis must consider the market. The latter implies a classical economic analysis that internalizes the political costs, for example, the cost to obtain unanimity.

Concepts such as supply and demand in this stylized model require a special interpretation. "Demand" consists of the ability to pay, either through money or through the ballot, of the well-organized interest groups in exchange for transfers of wealth, bearing net present value only for the groups that we discussed. Such "rent seeking" is not limited to the last beneficiaries of the redistribution of wealth. Finally, can enjoy the bureaucrats employees in important government departments, as well as private contractors dependent on the government whose budgets are included in these wealth transfer programs. On the other hand, "offer" arrangement consists in the absence or inability of the transfer is initiated. Offer transfer of wealth through the political process, the most constrained and is not part of a voluntary transaction. For the most part, tend to dominate producer groups by consumer groups lobbying done through the political process. For this reason, the transfer of wealth tends to take the form of concentrated benefits and distributed costs of the expenditure side or the revenue side of the budget. Future generations cannot commit a group to deal with lobbying.

Public choice theory fills the gap between economic theory and political reality of the Keynesian model and explains why "political brokers" raise the level of public spending, why choose to finance expenditure on economic growth through debt rather than taxes, preferring to reduce taxes even in times of large budget deficit. "Public choice" plays political economy analysis the realism that was sacrificed by economists when they withdrew from classical political economy to the neoclassical economics.

Browning, in 1975, developed a model based on majority vote to determine taxes and transfers in a social insurance system based on "pay-as-you-go" principle showing that, in the absence of fiscal illusion, young people and pensioners are likely to coalition in a majority voting tax rate in excess of the optimal savings rate from a private system. The events of the last decades confirmed that realistic vision of James Buchanan on the purpose of various economic policies and the importance of continuing consideration of the "game rules", while maintaining the basic set of rules. Buchanan is a proponent of the theory of balanced budget and a tight control on government activity.

Basically, the principles of public choice theory suggests the naivety of a model that shows that budgetary and fiscal policy makers are guided by the objectives of economic stabilization and effective fiscal uniformity. Rational political actors optimize budgetary policies in political rather than economic calculation. Political calculations in the absence of effective constitutional constraints systematically stimulate excessively high levels of public spending financed by excessive amounts of debt. Such results are attributed to poor judgment of some politicians. More correctly is to be regarded as predictable outcomes of a politics without romance. (Rowley et al., 2002)

4 Conclusion

In conclusion, the rational expectations theory and public choice theory bring forward particular aspects of the options and decisions involved in promoting a certain type of fiscal policy. Thus, whether fiscal and budgetary issues is addressed in terms of rational agents that take into account all information coming to their knowledge of public decision-maker about the fiscal-budgetary measures they intend to implement them, being aware of functioning of the economy, whether fiscal policy is viewed from the perspective of rational politicians who follow their own interests, even in the context of public decisions, appear obvious implications of such choices and decisions they produce on the fiscal budget individuals, economy, or society in general.

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