



## **ECONOMIC GROWTH VERSUS THE DOMINANT COMPONENT OF THE FISCAL POLICY: DIRECT OR INDIRECT TAXATION?**

---

---

**PhD. Candidate Antoniu PREDESCU\***

### **Rezumat**

Există, fără îndoială, o legătură strânsă între politica fiscală și creșterea economică; acest lucru este universal cunoscut și acceptat. Pe de altă parte, ceea ce este mult mai puțin înțeles se referă, în primul rând, la tipul de impozitare cel mai potrivit pentru o anumită economie - în acest caz, economia românească - și, în al doilea rând, instrumentul rațional prin care se poate decide, științific, și nu la întâmplare, tipul de impozitare utilizat pe termen lung în economia reală (dată), cu scopul conștient de a realiza creștere economică pentru anii următori.

### **Abstract**

There is, without a doubt, a strong connection between fiscal policy and the economic growth; this is universally known and consented. What is, on the other side of this matter, far less grasped is, firstly, the type of taxation best suited for a given economy – in this case, of the Romanian economy – and, secondly, the rational tool through the use of which one can decide, scientifically and not at random, the type of taxation used in the real (and given) economy, on the long term and with the conscientious aim of achieving economic growth for years to come.

**Keywords:** efficiency, growth, tax, price, elasticity

**JEL classification:** D42, E23, E60, L12, M11

---

*\*Lecturer, „Spiru Haret” University, Râmnicu Vâlcea.*

The impulse – not the *fiscal impulse*, in the ordinary meaning of this expression – given by a fiscal policy to the real economy by increasing the fiscal pressure, once issued, reduces the efficiency of the economic activities, so that they will produce a lower than optimal economic efficiency. This phenomenon is explained by the fact that the marginal income can not increase, from one day to the next one, relying (only) on the economic (productive) activity, while, on the other hand, the marginal cost born by the economic agents and by the natural persons tax payers increases in a quite short period of time due to the introduction/increase of the tax, which is taken easier by the first than by the latter..

This effect of the taxes, of levying, termed as *loss of efficiency (of the real economy) due to the tax (or loss of the importance of taxation effects)*, allows us to formulate the following economic and financial principle: if the fiscal policy doesn't provide the conditions required to increase taxpayers income on the long-term, it will be a break to the economic growth.

The newly introduced, or recently increased tax, changes strategically the behaviour of both types of tax payers – from whose incomes the state levies, directly or indirectly, a proportion required for its necessities. The reason to be of the producers is to sell the products of their activity, while the others<sup>1</sup> can not exist unless they buy what the producers sell. In each of the two cases, a component of the price – interface of all the selling-buying acts through which the economic growth is useful and, concomitantly, absorbed – more exactly, a quantifiable part of the price – is used to pay the newly tax/ tax increase.

The seller, seeing the *comprehensive* modification of the fiscal policy, increases the price, so that the initial value of the price is increased by a proportion, so that part of the sum obtained by the sale of each item will be used to pay the tax/increased tax.

The increment to the initial price is found in the price which the buyer pays, price which is increased due to the higher fiscal pressure; the increment was introduced exactly with the purpose to pay the tax, which becomes, at the level of the real economy, and at the level of

---

<sup>1</sup> The taxpayers mentioned here are natural persons, VAT payers.

all the taxpayers, by consolidation<sup>2</sup>, the proportion of budget revenue paid by the natural persons via the application of the fiscal policy, both direct or indirect.

In the first case, once the producers are taxed / levied additionally, the prices increase indirectly, as shown above. By indirect taxation the prices increase directly due the higher fiscal pressure, the burden being entirely to the end consumers, natural persons. Briefly, because part of the tax is paid by the consumers and *the other part* of the tax is paid by the producers, the amount which will be obtained by the state by introducing a new tax or increasing an already existing tax is, mathematically, the sum of the two parts.

In conclusion, and using only the final result of the quantified loss of efficiency due to taxation, its size is calculated as follows:

$$P_{\text{eimp}} = \frac{1}{2} \cdot \frac{I_{\text{mp}} \cdot Q}{P} \cdot \frac{\eta_C \cdot \eta_O}{\eta_C + \eta_O} \cdot I_{\text{mp}} \Leftrightarrow P_{\text{eimp}} = \frac{1}{2} \cdot \frac{I_{\text{mp}}^2 \cdot Q}{P} \cdot \frac{\eta_C \cdot \eta_O}{\eta_C + \eta_O} .$$

Very important, economically, and extracted from the above formula of calculation are the following:

( $\alpha$ ) the value of this loss increases with the square size of the tax;

( $\beta$ ) we have shown above that, in the long run, both the aggregate demand and the aggregate offer are elastic in a specific economy; the calculation formula of the efficiency loss due to the tax imposes the conclusion that the size of this loss increases with the *elasticity* of the aggregate demand and offer.

The type of income levying which produces minimal losses to the efficiency of the real economy, determined on objective bases, may be, if this expression is not improper, *calculated* easier if we relate to the economic and financial framework of an economic and financial crisis.

This is so, because the “contrast” of the (macro)economic *statu-quo* image is enlarged enough to justify the premises of origin: the importance of the correct choice that we have to do in order to have a maximal yield of the fiscal policy under the conditions of a (sustainable) economic growth, is maximal. A first argument shows

---

<sup>2</sup>

that, during a crisis, such as the current one in Romania (January 2010), the *consumption is severely reduced*, which is much more than sufficient reason not to implement a fiscal policy which would also decrease the consumption.

Anyhow, even if the economy would not be in the middle of a crisis – a crisis, if not of (over)production, then of (under)consumption – and more so if one intends to introduce, or already uses the predominant use of the indirect taxation of the incomes, consumption must be promoted, not for its exponential growth, rather in a more pragmatic way, on the background of an increase, or of modest fluctuation, around a value of balance (and implicitly, of the increment of the economic growth).

The stimulation of the economic growth uses, among other, the fiscal policy too; the dynamics of this macroeconomic instrument, whose (negative) result corresponds to the minimal amplitude of the negative effects obtained by the state if this dynamics is exacerbated by the incompetent/inadequate decision-making may be measured with several markers. These markers are useful when choosing the type of income levying, which will reduce to a minimal value the losses of efficiency due to the fiscal policy (e.g. whose focus is on the direct taxation) in Romania.

Normally, the very economic growth supplies the state, through all its economic and financial consequences, a fair share of the revenue to the state; a more complete expression is that the effects of the economic growth support the economic framework to which the fiscal policy and its governance are applied, and not vice versa. If the situation is reversed and if one uses more the indirect levying than the direct levying of the incomes, the sudden, rough application of the fiscal policy has a great structural flaw for the support of the volume of consumption.

If it is used strongly and in the presence of a protecting indirect taxation for consumption, the direct taxation of taxpayer incomes makes their income turn into *net income* which is at the disposition of the consumers for goods and services; the consumers are sovereign in terms of the proportion allotted to consumption, which can be maintained or even increased.

In the contrary situation, the picture changes: the direct taxation of the incomes supposedly inferior (as importance within the fiscal policy) to the indirect taxation, is, in principle, “tailored” to maintain – or even amplify – the increasing dynamics of the consumption, of the

economic growth<sup>3</sup>. In this case, the indirect taxation gets the better share in terms of shaping the income towards (re)establishing the proportions of income used by the consumers either for saving/investing, or for consumption.

The following effects occur:

- (1) The proportion from incomes allotted to consumption is, even in the most favourable perspectives, large in principle – supporting the state budget mainly through consumption requires the perpetuation of this reality, if not within the entire *oikoumene*, at least in Romania of the early 21<sup>st</sup> century;
- (2) Consumer incomes, particularly those of the natural (employed) persons will increase (either by saving, or by investments) slowly;
- (3) The immediate effect is a slowing long-term consumption, which can not expand without the increase of the income, the “source” of consumption.

If the fiscal policy is far from perfection (including from achieving the optimal economic and financial results), such as it is the case in Romania, the support of consumption (or, the increase of consumption, as required by a continuous economic growth) is, on the long-term, even more difficult to get.

To use the example of Romania, the measures which “omitted” their sustainable side, focusing exclusively on increasing the revenue to the budget by increasing the indirect fiscal debt of the consumer taxpayers, didn’t result in a sustainable substantiation of the consumption. The emergency ordinances of the Romanian government, together with the budget rectification, increased the VAT and other excises and thus yielded tax evasion too, and the “bill” also included the effects of the tax evasion, the substance of the “bill” being the result of disregarding the most basic economic principles.

The natural persons taxpayers played a role of investors and even of “saviours”, we may say, after the taxes started to grow (after 1994-1995), but this was not in favour of the economic growth; this role was much fading than before, more so as, objectively or not, the same taxpayers wanted to consume more and more, allocating thus increasing parts of their incomes to this purpose.

---

<sup>3</sup> Atkeson, A., Chari, V. V., Kehoe, P.J., “Taxing Capital Income: A Bad Idea”, *Quarterly Review (Summer)*, Federal Reserve Bank of Minneapolis, 1999, p. 11.

Reverting to the mathematical-economic basis of these considerations, the above formula highlights the importance of losing real economy efficiency that can be achieved (was achieved in the case of the Romanian economy) by numerous increases of the (indirect) taxation rates: so many successive increments of the fiscal debt ended by depressing not necessarily the aggregate demand, because the imports are a basic activity in Romania, but of the aggregate offer – of the patrimony and, particularly, of the results of the real economy in Romania.

Much more so, in order to secure the accession of Romania to the European Union, the indirect taxation of the income proved to be even more unable to support, on the short term, the increase of taxpayer incomes (the increase of consumption amplitude, on the long-term): the excises for fuel increased, *exempli gratia*, in order to report the “adoption” of the community acquis in this case; however, the authorities failed to notice, if we may say so, that the income of the large majority of the taxpayers could not be increased, *ex nihilo*, not even with an euro cent, much less with the same ration.

A decreased VAT for the staples doesn't exist yet (2010). The taxpayers on low incomes don't even have the chance to save, or to invest, more so they can consume more, on healthy financial bases, not by “credits for consumption” which are more or less reimbursed (in time). Furthermore, the higher consumption was and still is largely a consumption of imported (industrial) products, whose purchase contributes only too little to the consolidation of the autochthonous economic growth.

On the grounds of these arguments, we reached the following conclusion: at least for an “emerging” economy, which uses a lot to produce a little, the stress must be on the direct taxation of incomes.