Fiscal Policy and Budgetary Framework

At the end of this topic a student should be able to:

- distinguish between the current and capital parts of the government accounts
- identify the main sources of government expenditure
- discuss measures that a government can take to manage a budget deficit, surplus or balanced budget
- differentiate between expansionary, neutral and contractionary fiscal policies and examine how the government could use these policies in an attempt to stabilise the business cycle
- discuss the limitations of fiscal policy in stabilising business cycles
- discuss how being a member of the EU and the Eurozone influences Ireland's ability to implement fiscal policy

Budgetary Framework

- **Budgetary process – see page 270/1 in the textbook**
  - Video here
  - More information here

- **Government Current Budget:**
  - **Current revenue (day-to-day)** is money collected in taxes (direct / indirect; and other income during the year. Eg VAT; Income Tax revenues; Stamp Duties, profits from state companies, interest on loans to local authorities, fees charged for services (passports etc), national lottery surplus
  - **Current expenditure (day-to-day)** includes ages for public servants, Social Welfare payments
  - Most of this is voted on by the Oireachteas with the exception of certain payments like debt servicing payments, judges salaries and EU budget contributions which have no political interference
  - **Current Budget Deficit is where** current government expenditure exceeds current government revenue (day-to-day revenue and expenditure). A **Surplus** is the opposite.
  - **A balanced budget is where current revenue equals current expenditure**

- **Government Capital Budget:**
  - Outlines the government's planned expenditure on items not used up during the year but which increase the productive capacity of the country.
  - Examples of capital income includes sale of semi state company or sale of state land. Loan repayments from local authorities. Grants from the EU
  - The money to pay for capital expenditure is usually through borrowing by the government. Examples of capital expenditure include building roads, building hospitals.
  - **Where your money goes**

- **Exchequer Borrowing Requirement (Exchequer Balance)**
  - The amount borrowed by central government to fund a current budget deficit and any borrowing for capital purposes/current budget deficit plus borrowing for capital purposes.

- **Public Sector Borrowing Requirement (General Government Balance)**
  - The exchequer borrowing requirement plus borrowing for semi-state/state sponsored bodies and local authorities.

- **Positive consequences of a Current Budget Surplus**
  - **Reduced inflationary pressures.**
    - The government is withdrawing more money from the economy than it is putting in. This tends to have a deflationary effect in the economy.
  - **Managing our finances.**
    - The existence of a budget surplus means that government does not have difficulty in controlling its finances. This can lead to confidence in the economy and attract investment.
  - **Adhering to EU guidelines.**
    - The fact that a budget surplus exists indicates that the country is meeting the EU agreed guidelines without any difficulty. This alleviates the need for the EU to comment adversely on government economic policy.
  - **Scope for taxation reforms.**
    - The fact that a surplus exists indicates that scope exists for reform in the taxation system in the country. This should allow for improvements in the tax system allowing people to retain more of their income e.g. widened tax bands etc.
  - **Uses of this increased govt. revenue.**
    - With increased revenue flowing into the government, they now have the ability to make use of this additional revenue. They may use for current projects e.g. services or on long term projects e.g. infrastructure.

- **Negative consequences of a Current Budget Surplus**
  - **Rise in conflicting expectations.**
    - When citizens observe the budget surplus they may demand improvements in state services e.g. health services; education provision etc. However, the demands/expectations made on the government may conflict.
  - **Public Sector Workers.**
    - When public sector workers see this budget surplus they may see it as an opportunity for wage negotiations. Workers may thus demand pay increases and /or an increase in the level of the workforce.
  - **Tax reductions.**
    - Taxpayers who feel that they are paying too much tax may feel aggrieved. They may demand reductions in their tax / improved equity in the tax system.
  - **Discontinuity in Social Partnership.**
    - The existence of the budget surplus may cause discontent within society. Citizens may feel that certain sectors are benefiting more from government policies. May prove difficult in approving national agreements.
  - **Government financial planning.**

        - The surplus may indicate that the planning by the government was not sufficiently accurate at budget preparation time.
    - **Opportunity costs of a surplus.**
        - The budget surplus may have been achieved by the reduction of expenditure on services within the country. Thus essential services such as health, education etc may deteriorate

- **Consequences of a Current Budget Deficit**
    - **Additional taxation**
        - The government needs to increase revenue to finance its activities and so has increased the rate of VAT; introduced the Property Tax and Septic tank tax. It also plans to introduce water charges.
    - **Cuts in public expenditure**
        - In the recent budget the rate of child benefit was cut and this affects all families in the state resulting in a reduction in their standard of living etc...
    - **Reduction in the provision of state services**
        - The provision of services such as SNAs; home help for care assistants is causing difficulties for sectors of the population.
    - **Troika intervention**
        - The requirement to reduce the current budget deficit by the Troika means that the Troika can intervene and advise the Irish government on policy measures within the economy.
    - **Public sector pay**
        - The government is insisting that the public sector pay bill is reduced and that measures to increase efficiencies in public services must be introduced.
    - **Reduction in aggregate demand / job losses**
        - With the additional taxation consumer spending has fallen. This has resulted in job losses particularly in the retail sector.
    - **Loss of confidence / emigration**
        - The impact of extra taxation; reduced consumer spending; job losses etc. means that people are fearful about the future which affects business confidence. People, who are mobile, are emigrating.
    - **Moderation in citizens expectations**
        - Citizens are aware of the current financial position. They may accept more readily charges for state / local services; increased taxes and a reduction in state services for some individuals e.g. fewer hours for care assistants etc.

- **Relationship between a budget deficit and national debt**
    - A government budget deficit exists when total government expenditure exceeds total government revenue. A budget deficit is financed by increased government borrowing.
    - National debt is the total amount (cumulative) of government borrowing which is outstanding (due / owed). A budget deficit will result in an increased national debt in absolute terms and a higher cost of servicing the national debt.

- **Reasons for the National Debt**
  - **Improved Public services:**
    - If the increased debt is caused by an increase in current borrowing, the government may continue to spend on public services resulting in a continuation of these services.
  - **Increased spending on infrastructure:**
    - If the increased debt is caused by an increase in capital borrowing then there may be greater spending on the state's infrastructure, which may assist the future growth of the economy.
  - **Future Economic Growth:**
    - Increased National Debt may boost aggregate demand and may provide opportunities for further economic growth.
  - **Self-Liquidating debt:**
    - If the return on the borrowings is able to meet the cost of repayments then the borrowing has been self-liquidating.

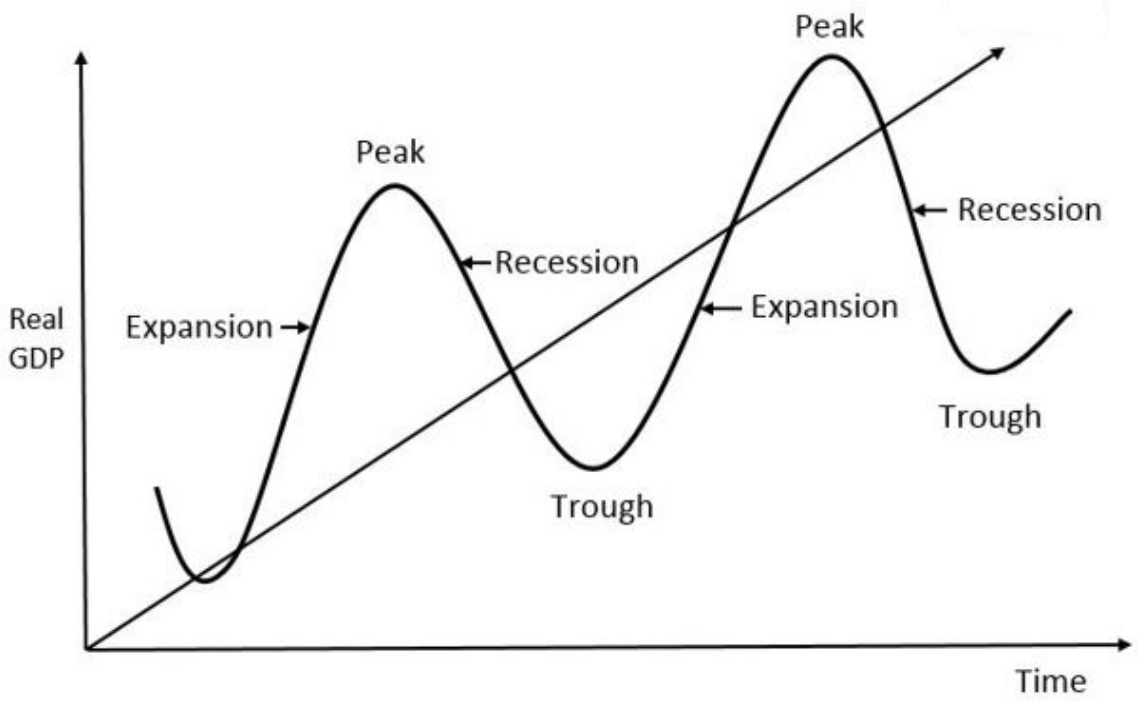
- **Dealing with Budget Deficits and Surpluses – the consequences**
  - **<u>Deficit</u>**
    - **Increase Revenue**
      - Property Tax
      - Excise Duty Increase
      - VAT Increase
      - DIRT Increase
    - **Cut Expenditure**
      - Cutting public service pay/numbers
      - Cutting Social Welfare payments
      - Cutting services
  - **<u>Surplus</u>**
    - **Increase Spending**
    - **Increase Saving for a "rainy day"**
  - **See pages 275 - 278**

<u>Fiscal Policy</u>

- **Fiscal Policy:** Any action taken by the government that influences the **<u>timing</u>**, **<u>magnitude</u>** and **<u>structure</u>** of **<u>current revenue or expenditure</u>**
- The purpose of fiscal policy can be to:
  - Stimulate economic growth
  - Keep inflation under control
  - Stabilise economic growth to minimise boom/bust **business cycles**

- **The Business Cycle**
  - Economies go through a regular pattern of ups and downs in the value of economic activity. This is known as the "the business cycle".
  - The business cycle is characterised by four main phases:

- Expansion/Boom: high levels of consumer spending business confidence, profits and investment. Prices and costs also tend to rise faster. Unemployment tends to be low as growth in the economy creates new jobs
- Recession/Trough: falling levels of consumer spending and confidence mean lower profits for businesses – which start to cut back on investment. Spare capacity increases + rising unemployment as businesses cut back and reduce stocks. A depression is a prolonged period of declining GDP - very weak consumer spending and business investment; many business failures; rapidly rising unemployment; prices may start falling (deflation)
- Recovery: things start to get better; consumers begin to increase spending; businesses feel a little more confident and start to invest again and build stocks; but it takes time for unemployment to stop growing
- Watch this and this



- Every business is affected by the stage of the business cycle, but some businesses are more vulnerable to changes in the business cycle than others. For example, a business that relies on **consumer spending** for its revenues will find that demand is closely related to movements in GDP. During a boom, such businesses should enjoy strong demand for their products, assuming that the products are actually what customers want! But during a slump, the business has to "ride out the storm" – suffering a sharp drop in demand.
- During the housing-market inspired boom of the early 2000's, many retail and consumer goods businesses took advantage of the boom. Consumers were

prepared to take on significant personal debt in order to finance their purchases but, as we know, this didn't last.

- Businesses whose fortunes are closely linked to the rate of economic growth are referred to as "**cyclical**" businesses. Examples include:
  - Fashion retailers
  - Electrical goods
  - House-builders
  - Restaurants
  - Advertising
  - Overseas tour operators
  - Construction and other infrastructure firms
- By contrast some businesses actually benefit from an economic downturn. If their products are perceived by customers as representing good value for money, or a cheaper alternative than more expensive products, then consumers are likely to switch. Good examples that were featured in the UK media during the previous recession included:
  - Value retailers (e.g. Aldi, Lidl)
  - Fast-food outlets (e.g. Dominos, Subway)
  - Domestic holidays (e.g. B&Bs and holiday cottages)
  - Chocolate – for some reason, chocolate sales always increase strongly during an economic downturn!

- **Expansionary Fiscal Policy**
  - Expansionary policy is undertaken when increased government spending or reduced taxation used to increase aggregate demand and achieve economic growth.
  - Expansionary fiscal policy usually involves borrowing by the government.
  - According to Keynesian economic theory, the government should increase demand in order to boost growth. Keynesians hold the belief that the primary driving force in an economy is consumer demand.
  - **Watch this**
- **Contractionary Fiscal Policy – See page 280**
  - Contractionary fiscal policy is undertaken when reduced government spending or increased taxation
  - It is used to curb aggregate demand and prevent inflationary pressures within an economy
  - **Watch this**
  - **Watch this too**
- **Fiscal Neutrality**
  - This rare situation occurs where government spending is equal to government revenue

- **Limitations of Fiscal Policy in stabilising business cycles**
  - **Ability to borrow/Borrowing Costs**
    - The ability to borrow at affordable interest rates will impact a countries ability to initiate expansionary fiscal policy. Countries with poor credit ratings or those with large Debt/GDP ratios will struggle to borrow at affordable rates

- **EU Monetary Policy**
  - If the ECB is trying to control inflation through monetary policy Ireland's fiscal policy will have to be consistent with that goal. Expansionary policies such as income tax cuts would not help to curb inflation.
- **EU Budgetary Controls**
  - EU countries must ensure that their budget deficit is no more than 3% of their GDP and that national debt should be no more than 60% of GDP. Flexibility is given from the EU depending on economic circumstances, but this is the stated goal and may limit a countries ability to implement fiscal policy
- **Hard to stimulate confidence**
  - Consumer pessimism is hard to control through fiscal policy. A government may try and stimulate consumer activity through taxation cuts but if consumers do not have confidence about the future of the economy, cuts to taxes may have little impact in stimulating aggregate demand.
- **Open economies may struggle**
  - Governments will often try to inject money into the circular flow of income through building large capital projects. In open economies, such as Ireland, there is a strong propensity for those injections to leak to other countries, therefore the full benefit of the injection may not be felt by the Irish economy

- **Administrative Lag**
  - Governments are often slow to process responses to economic shocks. Bureaucracy in the civil service may mean that it take too long for a change in fiscal policy to come into effect, and when it does, the remedy may be insufficient given that the problem might have changed.
- **Watch this**

How being part of the EU and Eurozone influence our ability to implement fiscal policy – Page 281/2

- In 2012 the Irish people voted to adopt the EU's Fiscal Stability Treaty
  - As part of this treaty we have agreed that;
    - Our government's **structural budget deficit** must not be bigger than 0.5% of GDP
      - The structural deficit is that part of the deficit which is not related to the state of the economy. This part of the fiscal deficit will not disappear when the economy recovers. A structural factor might be the long-term effects of an ageing population or perhaps the underlying level of personal and corporate tax avoidance.
      - In essence it is our deficit measured by taking away the effects of slower or faster than normal economic growth and the effects of one off government incomes or expenditure

        - If a government exceeds the 0.5% rule the EU commission would trigger a process to correct Ireland's deficit
        - If the government does not comply with these rules consistently we could be sanctioned to the tune of 0.1% of our GDP
    - Government Debt to GDP ratios must not exceed 60%
        - Where they do (as in Ireland's case) we must demonstrate to the EU commission that we are on a path to correct our debt problem
- To comply with the EU treaty the Irish Government enacted the **Fiscal Responsibility Act 2012** which brought the EU guidelines into Irish law
    - As part of this the Irish government established the **Irish Fiscal Advisory Council.** The council is an independent statutory body. Its purpose is to provide an independent assessment of the Irish government's budgetary forecasts and proposed fiscal policy objectives.