Budget Framework

Chapter 12 Part II

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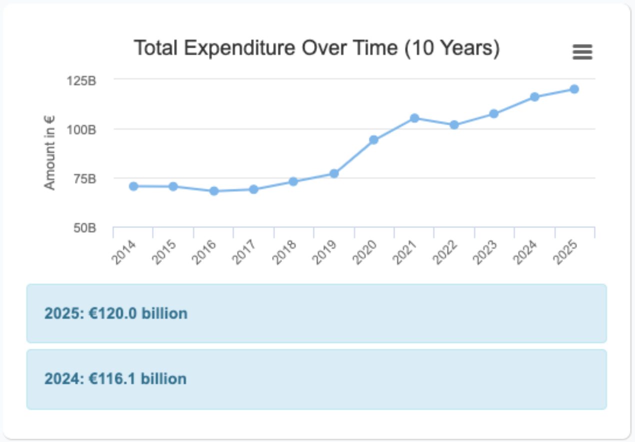
Learning Outcomes

In this chapter we will:

- identify the main sources of government revenue and expenditure; distinguish between the current and capital parts of the government accounts
- 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

Fiscal Policy & Budgeting



This chapter will aim to bring together the different strands of fiscal policy and the National Budget.

1) Government revenue: main sources (what the State takes in)

Tax revenue (largest source)

- **Direct taxes:** Income Tax (PAYE), USC, PRSI (social insurance contributions)
- **Indirect taxes:** VAT, Excise duties (fuel, tobacco, alcohol), Carbon tax
- **Corporation tax:** tax on company profits

Non-tax revenue (also important)

- **Charges/fees:** licences, public services, fines
- **State income:** dividends/profits from State bodies, rents/royalties
- **EU receipts:** some funding streams (depends on programme)

Key point: *Borrowing is finance, not revenue* (it funds spending when revenue is not enough).

1) Government expenditure

Current spending (day-to-day running costs)

- **Pay** (public sector wages) and **pensions**
- **Social welfare** transfers (jobseeker payments, child benefit, etc.)
- **Health & education running costs** (staffing, medicines, materials)
- **Interest on the national debt**

Capital spending (long-term investment)

- **Infrastructure:** roads, rail, water, energy networks, broadband
- **Public buildings:** schools, hospitals
- **Housing and major upgrades** (building/renovation programmes)

1) Current vs capital accounts (the distinction you must be able to state)

Current account ("everyday" budget)

- **Current revenue:** mainly taxes + non-tax income
- **Current expenditure:** wages, welfare, running costs, interest
- **Aim:** should be sustainable year-to-year (not relying on borrowing for routine bills)

Capital account (investment budget)

- **Capital expenditure:** building assets that last many years
- Can be financed by **capital receipts** and/or **borrowing**
- **Logic:** borrowing can be more defensible when it funds long-term productive assets

current spending funds *consumption/operations* while capital spending generally consists *investment in assets*.

Fiscal Policy: Types and Limitations

Fiscal Policy – Definition

Fiscal policy refers to measures used to influence scope, size and magnitude of government current revenue and government current expenditure.

Contractionary fiscal policy involves raising taxes and/or reducing spending to combat inflationary pressure, while **expansionary fiscal policy** involves reducing taxes and/or raising spending to combat recessionary pressure.

Neutral fiscal policy is a structure of taxes and transfers that keeps distribution of income unchanged following positive or negative shocks – fiscal neutrality implies tax shouldn't distort economic behaviour.

Limitations of Fiscal Policy

1. Crowding out: Monetarists argue that the State cannot increase aggregate demand. This is because they must borrow from the private sector. So the private sector subsequently has less funds for private investment.
2. Time barrier: if the State wants to change taxes or expenditure, they must draft a bill, debate in the Dáil and have it signed into law. This takes time. Often, by the time the policy is imposed, it may not have the desired effect.
3. Gov't Inefficiency: some claim fiscal policies promote wasteful use of resources. The State may employ jobseekers in recession but may hold onto them too long, even as the economy grows.

Approaches to Fiscal Policy

Keynes

1. He suggested the State should intervene in the economy following recession to move the economy closer to full employment – by spending on capital/infrastructure projects.
2. He opposed the Classical theory that in recession, wages would fall, the demand for labour would rise & recovery would follow. Keynes said if wages fell, demand would fall (as real income fell) leading to worse recession.
3. Keynes favoured State intervention via fiscal stimulus (lowering taxes and raise gov't spending) to stimulate demand.

Monetarism

1. **Control Money Supply:** Monetarists support tight control of money supply to control inflation. Limiting credit availability, keeping interest rates high should control borrowing.
2. **Inflation:** Low inflation boosts competitiveness, relatively cheaper exports, higher export demand and job creation in the long run. Firms should limit wage increases to avoid cost-push inflation.
3. **Laissez Faire Principles:** Monetarists favour *laissez-faire* policies like minimal state intervention, de-regulation of markets & privatisation.

Classical Theory

1. Supply creates its own demand. Thus, they advocated an expansion of supply and not of demand as a solution to economic problems.
2. They advocated low taxes as they would encourage production (or at least remove a disincentive to produce goods and services) which would create employment.
3. They promoted the deregulation of markets (the removal of legal restrictions on how companies are allowed to act) and the privatisation of state firms.

Privatisation

"Privatisation" is the term used to describe the sale or transfer of public sector services or assets to the private sector. Privatisation can be total (ie sell off the whole company) or partial (sell off part, but retain some shareholding – often retaining enough to ensure majority control).

Since the 1980's many European economies have embarked upon a policy of reducing state involvement in companies which previously had been publicly owned, and transferring this ownership to private individuals and non-government institutions. Since 1991, many major Irish "semi-state" bodies have been privatised. The sale of these companies raised revenues for the Irish government and, in most cases, was reasonably successful.

Arguments in Favour of Privatisation

1. Price and Quality Improvements for Consumers: With the need to maintain a competitive edge, privatised firms are often forced to implement improvements in their product in terms of price, speed of service, quality. If ESB was privatised they'd improve services to succeed in the market.
2. Increased Efficiency for the Company: Privatisation forces firms to become more efficient or they will fail. Entrepreneurial thinking is encouraged and management can make decisions (especially risky or unpopular ones) far more quickly, without the bureaucratic red tape associated with government organisations. For example: Irish Sugar was an unprofitable strike-ridden firm in the 1970s and 1980s. It was privatised, renamed itself Greencore, and is now very efficient and profitable.
3. Capital may be more available for the Company: In the current economic climate of government cutbacks and restricted spending, private firms may now be best placed to raise the capital necessary for expansion or renovation of an industry.
   The Irish government has already had to pull the plug on a range of public sector projects and are showing a preference for Public Private Partnerships, like toll roads.

It can also be pointed out that:

- Some industries simply don't need government involvement – eg: why should it be the government who run the airline, surely it should be an airline company?
- Selling off a business doesn't mean the gov't loses control – it can still regulate business operation.

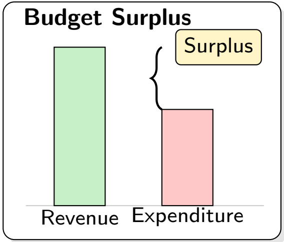
Arguments Against Privatisation

1. Loss of Revenue to the Government: While the sale of profitable firms yields a large once-off sum for the government, it also means that they are forgoing all future revenue that would result from the annual profits of these firms. The government need to weigh up very carefully whether the short-term gain is worth losing out on these profits from now on. For example: Selling off Irish Life (now part of Irish Life Permanent Bank) was very profitable for the government, but it subsequently lost out on years of profits
2. The Government may be left with only Unprofitable Services: Nobody is going to buy a firm that is unprofitable. Therefore the government must continue to provide it, if it is considered worthwhile. However, if the government sells off all the profitable companies, it will have nothing to "cross-subsidise" the loss-making firms and must bear all the costs itself. For example: There is little interest in the sale of Iarnrod Eireann as it's seen as unprofitable.
3. Increase in Unemployment: Transitional unemployment is likely to occur as newly-privatised firms strive to become more efficient by laying off unnecessary labour. This increases demands on government finances (paying the costs of unemployment benefit, and losing the income tax previously paid to them) and the taxpayer loses out so that the business can make more profit. For example: If Bus Eireann were sold a lot of redundancies would occur to make it more efficient so it could compete as a private company.

The National Budget

National Budget – Definition

A statement of the government's expected revenue and expenditure for the coming year.



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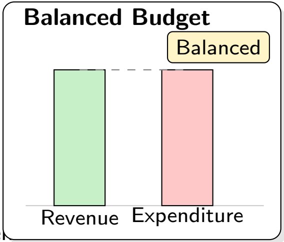

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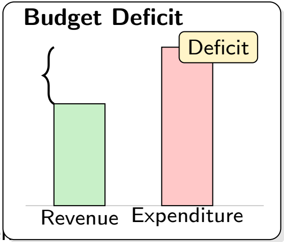

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Higher revenue (e.g. strong tax takes) than spending.
Options: pay down debt, invest more, or save.

Revenue equals spending.
Neutral stance on demand (other things equal).

Spending exceeds revenue.
Gap typically financed via borrowing.

Ways of Reducing Current Budget Deficits (Revenue)

Increase Indirect Taxes: By increasing taxes such as VAT and excise duties the government would aim to increase tax revenue from consumption. *The effects of this may be:*

- Increased smuggling in order to evade tax.
- Increased inflation as the increase is automatically built into the price.
- Reduction in aggregate demand as prices have increased.

Increase Direct Tax/Pension levy: By increasing taxes such as PAYE, CGT or the pension levy the government would aim to increase their tax revenue from wealth and incomes. *The effects of this may be:*

- Increased numbers working in the 'black economy' in order to evade tax.
- Decrease in employment as the cost of wages will increase – decreased incentive to work.
- Increase wage demands which may lead to industrial disputes.
- Decrease in aggregate demand as real incomes and spending power falls.

Ways of Reducing Current Budget Deficits (Spending)

Decrease Numbers Employed in the Public Sector: Offer redundancy packages to those working in the public sector. *The effects of this may be:*

- Increase in short-term costs in meeting redundancy payments.
- May increase long run unemployment if no work is available in the private sector.
- Reduction in aggregate demand as real incomes and spending power have decreased.
- Deterioration in public services.

Decrease Wages in the Public Sector: Introduce a pay freeze where workers wages will not increase over a period of time. *The effects of this may be:*

- May lead to industrial disputes.
- Skilled workers may leave for the private sector or emigrate.
- Discourage effort and motivation in the sector, reducing efficiency in the long-term.

Reduce State Services or Increase their Charges: Cut services such as medical card, cervical cancer vaccine, book grants etc in each government department. *Potential effects include:*

- Those on lower incomes may suffer a dramatic fall in standard of living.
- May increase costs in the long run in order to reintroduce services.
- May lead to industrial disputes and public protests by affected citizens.

The Negative Economic Effects of a Current Budget Deficit

1. **Inflation:** As the government is putting more money into the economy than it takes out, this causes Aggregate Demand to rise. This boost in Agg Demand may raise demand pull inflation.
2. **The Deficit must be met by Borrowing:** Ireland's national debt stands at €123.5 billion. Ireland must keep its debt to GDP ratio at 60% or less. Ireland's debt to GDP ratio was 108.2% in 2011. Since the ratification of the Treaty on Stability, Coordination and Governance, the government cannot be seen to allow current deficits to continue. Violation of Maastrict Treaty would damage Ireland's international reputation.
3. **Reduced Investment Funds:** Also, if the Irish State borrows from Irish banks in order to finance a deficit, there are less funds available for private entrepreneurs to use for investment. This process of public borrowing reducing funds available to private entrepreneurs is known as crowding out.

Crowding Out: An economic theory explaining an increase in interest rates due to rising government borrowing in the money market.

4. **Increase in Imports:** As Ireland has a relatively high Marginal Propensity to Import, this injection of money into the economy might be spent largely on imports, not causing growth while having negative consequences on the Balance of Payments.
5. **Not Sustainable Growth:** Any increase in economic growth that might occur may depend on the continued injection of government funds. As this is unsustainable in the long run, the net effect may be a return to economic output that existed before the deficits and a large national debt.

The Negative Economic Effects of a Current Budget Surplus

1. **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.
2. **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.
3. **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.
4. **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.
5. **Government Financial Planning:** The surplus may indicate that the planning by the government was not sufficiently accurate at budget preparation time.
6. **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 have deteriorated.

Revenue Buoyancy and Fiscal Drag

Revenue Buoyancy – Definition

Revenue Buoyancy occurs when actual taxation revenue collected during the year is greater than that which had been planned for.

When the government removes more money from the economy than it puts in this reduces the Circular Flow of Income. This causes a reduction in Aggregate Demand and as such has a Deflationary Effect. This Deflationary Effect is known as Fiscal Drag.

Fiscal Drag – Definition

Fiscal Drag is the deflationary effect that occurs if government revenue is greater than government expenditure.

The Positive Economic Effects of a Current Budget Deficit

1. **Economic Growth:** A budget deficit increases the circular flow of income and increases aggregate demand. This increase in aggregate demand may increase the national income of the country.
2. **Employment:** As a result of this economic growth firms may employ more people in order to meet the increased demand. This would result in a higher standard of living for those who managed to secure employment.
3. **Taxes:** With an increase in Aggregate Demand, the government would start to collect more money through indirect taxes. This money could be used in other sectors of the economy to further stimulate growth or be kept to ensure that a current deficit does not occur next year.
4. **Improvement in Services:** The extra money being spent by the government may result in improved public services. E.g. Improved services from the ESB or Bord Gaís.
5. **Redistribution of Income:** The government could use the extra money that it is spending to alleviate the economic hardship endured by the poorest citizens of the country. E.g. Increase welfare payments of the old age pension.

EU & Eurozone membership: what changes for Irish fiscal policy?

Membership of EU and Eurozone mainly affects fiscal policy through:

- **EU fiscal rules and surveillance** limits (debt cannot exceed 60% of GDP) and monitoring
- **No independent monetary policy** the ECB sets interest rates for the entire Eurozone area.
- **EU law constraints** EU competition law and state-aid rules shape how the gov't supports firms

Why the EU sets fiscal rules

In a currency union, one country running very risky budgets can create higher risk for others. For example, in the lead-up to the financial crisis of 2008, Greece built up a large amount of debt. When the crisis hit, creditors (the people/institutions Greece borrowed from) began looking for their money back. This triggered a European debt crisis which dragged on for many years.

A number of groups like the EU, Eurozone and the IMF had to step in and offer financial assistance, costing a huge amount to member states. In order to receive this financial assistance, the Greek gov't had to agree to deep cuts to its public sector (austerity) in order to recover the dire position of its public finance. However, this caused great harm to the Greek economy. Today, 1 out of every 3 people born in Greece is at risk of living in poverty.

In light of such adverse events, the fiscal rules aim to discourage large, persistent deficits, to require governments to produce budget plans and to trigger corrective procedures if targets are breached

Implications of EU and Eurozone membership

1. Less freedom to run large deficits

Expansionary fiscal policy is possible, but large deficits can face EU and market pressure. The State may need a **medium-term plan** to return debt/deficits to safer paths. This is very positive because it forces the gov't to consider the long-term rather than just short sighted policies to win the next election.

2. No exchange rate tool (Euro membership)

Ireland cannot devalue its own currency to boost competitiveness. Adjustment relies more on **prices/wages**, productivity, and fiscal choices. These can be more difficult to adjust.

3. Monetary policy is set by the ECB

Interest rates are not chosen for Ireland alone. Fiscal policy is vital to address Ireland-specific shocks

Despite these limitations, EU/Eurozone membership supports Ireland's fiscal capacity in other ways:

- **Lower transaction costs** and more trade/investment due to the common currency
- **Credibility:** being in the Eurozone can strengthen investor confidence (when budgets are credible)
- **Access to EU funding programmes** in certain areas (investment support)
- **Policy coordination** and shared frameworks (common standards and oversight)