Introduction

The role that the government plays in an economy should never be underestimated. The economic policies that the government enact play a vital part in the development and the general workings of an economy. In general, the government has two main types of policies that it can use to control an economy (reduce inflation) or stimulate an economy (promote economic growth). They are Monetary Policy and Fiscal Policy.

Monetary Policy: Those actions by the ECB, which influences the money supply, interest rates and the availability of credit.

As is suggested in the definition, the Irish government does not control the Monetary Policy that it is subjected to by the European Central Bank (ECB), and as such this is not an instrument of economic policy available to the Irish government.

Fiscal Policy: Any action taken by the government which influences the timing, magnitude and structure of current revenue and expenditure.

The Irish government still retains control of its Fiscal Policy but only up to a point. Since Ireland has ratified the Treaty on Stability, Coordination and Governance, the Irish government is required to write into law the following four fiscal rules.

1) Debt-to-GDP ratio should be 60% or less;
2) Government deficits should be 3% or less;
3) Government structural deficits should be 0.5% or less
4) If the debt-to-GDP is "significantly below 60% and where risks in terms of long-term sustainability of public finances are low" the structural deficit can be up to 1.0%

Structural Deficit: A budget deficit that results from a fundamental imbalance in government receipts and expenditures, as opposed to one based on one-off or short-term factors.

A deficit occurs when the government spends more money than they received in a given year.

Each of these rules (which are now law) effect the governments ability to control the economy and as such they effect you. The question has to be asked therefore, what does any of them mean?

To explain these rules, the reasons for these rules, the general government budget, how it is comprised and what it contains and the National Debt, its effects and consequences are the purpose of this handout.

The Irish Government

The Irish government can be split into two broad categories.

1) **The Central Government:** is composed of the Dáil, the Seanad and the Civil Service.
2) **Local Government:** is composed of the various urban and county councils which provide certain government services in their own local area.

The finances of each play a huge role in the National Budget, but for the moment wee will take each of them in turn.

The Central Government Budget

The government budget is divided into two categories. The Current Budget and the Capital Budget.

Government Current Budget: Outlines the government's planned revenues and expenditures for the forthcoming year for day to day purposes

Government Capital Budget: Outlines the governments planned expenditure on items not used up during the year but which increase the productive capacity of the country

As was said previously, when the government spends more in a year than it takes in, this is known as a deficit.

The Economic Effects on the Irish Economy when the government Reduces the Deficit

1) **Reduced Standard of Living:** Taxpayers will have lower disposable incomes due to higher taxes and their standard of living will fall.
2) **Loss of Public Services:** Some public services may be discontinued (bus transport routes / less Special Needs Assistants); others may fall in standard (health services) while more may have to paid for example household charges.
3) **Changed Ownership of Strategic State Assets:** Some state bodies may be privatised affecting consumers (prices), employees (non-employment) and the government (revenue).
4) **Public Sector Effects:** The numbers employed in the public sector will fall; wages may be reduced and this may add further to the numbers unemployed.

5) **Level of Economic Activity:** Lower disposable incomes has reduced domestic demand and this may result in an increase in the numbers unemployed.
6) **Growth in the Black Economy:** More people may be willing to participate in the black economy due to reduced incomes and the possibility of lower prices being charged in the black market.
7) **Widening Gap between Rich and Poor:** Cutbacks in rate of social welfare payments; coupled with stricter eligibility requirements may mean that social welfare recipients suffer. Changes in taxation and expenditure cuts may have a greater effect on lower income groups.
8) **Public Unrest:** People may become involved in protests / strikes which may disrupt economic activity. Some citizens may decide to emigrate seeking a better future.

The Government Current Budget

Each year, the Minister for Finance presents the current budget to the Dáil which outlines the government's planned revenues and expenditures for the forthcoming year for day to day purposes.

Current Revenue: is money collected by the central government in the form of taxes (direct / indirect) and other income during the year.

E.g. Income Taxes, Corporation Taxes, DIRT, VAT and Stamp Duty.

Current Expenditure: is money spent by the central government on day to day items.

E.g. Wages of Public Sector employees like teachers, Gardaí, nurses etc.

Overleaf is a more complete list of Central Government Current Revenue and Central Government Current Expenditure.

Current Budget	
Revenue	**Expenditure**
Income Tax	Salaries of Civil Service, Army and Gardaí
Value Added Tax	Running Costs of government departments (stationary, light and heat etc)
Corporation Tax	Social Welfare Payments
Capital Gains Tax	Interest on the National Debt
Capital Acquisitions Tax	Grants to Local Authorities for Current Expenditure
Excise Duties	Central Fund Services
Stamp Duties	
Customs Duty	
Proceeds of the National Lottery	
Interest on Loans given to semi-state bodies and Local Authorities	

Note: Central Fund Services refer to government expenditure which is outside government control. This includes things like the salary of the President, salaries of judges and our contribution to the EU).

The central government current budget can end in one of three ways. It can be either a budget surplus, a balanced budget or a budget deficit.

Current Budget Surplus: is a situation where current government revenue exceeds current government expenditure.

Current Budget Deficit: is a situation where current government revenue is less then current government expenditure.

A Balanced Budget: is a situation where current government revenue is equal to current government expenditure

The Positive Economic Effects of a Current Budget Surplus

1) **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.
2) **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.
3) **Adhering to EU Treaty:** The fact that a budget surplus exists indicates that the country is meeting the EU Stability, Coordination and Governance Treaty without any difficulty. This alleviates the need for the government to take automatic corrective action.
4) **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.
5) **Uses of this Increased Government 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.

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: The 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: 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.

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 rise in Aggregate Demand may cause demand pull inflation to increase.
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 as it is illegal.
3) **Reduced Investment Funds:** Also, if the Irish government were to borrow money from Irish banks in order to finance a deficit, this would mean that there would be 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 fact that running a current budget deficit is not sustainable, combined with the national debt of some major EU member states rising to never before seen levels (Ireland, Greece, Spain, Italy etc), The Treaty on Stability, Coordination and Governance brought in the rules stated at the beginning of the handout in order to try to promote sustainable growth in EU member states. Below is a short excerpt from the Treaty.

BEARING IN MIND that the need for governments to maintain sound and sustainable public finances and to prevent a general government deficit becoming excessive is of essential importance to safeguard the stability of the euro area as a whole, and accordingly, requires the introduction of specific rules, including a "balanced budget rule" and an automatic mechanism to take corrective action.

With the goal of sustainable economic growth in mind and the fact that many EU member states are operating well outside the fiscal limits set out by the treaty, (Ireland Debt/GDP Ratio 108.2%, Italy's Debt/GDP Ratio 120.1%, Portugal Debt/GDP Ratio 107%, Spain Debt/GDP Ratio 72.1% and the EU average is 88%), the Ministers for Finance in the EU member states have to control Current Deficits. Below is a list of ways they could do this and the effects of so doing.

Ways the Government could Reduce Current Budget Deficits

Revenue

1) **Increase Indirect Taxes:** By increasing taxes such as VAT and excise duties the government would aim to increase tax revenue from consumption.

Effect

- 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.

2) **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.

Effect

- 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.

Expenditure

1) **Decrease Numbers Employed in the Public Sector:** Offer redundancy packages to those working in the public sector.

Effect

- Increase in short-term costs in meeting redundancy payments.
- May lead to increase in long term 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.

2) **Decrease Wages in the Public Sector:** Introduce a pay freeze where workers wages will not increase over a period of time.

Effect

- 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.

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

Effect

- 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.

4) **Reduce Social Welfare:** This will reduce current expenditure and reduce the budget deficit.

Effect

- Those on lower incomes may suffer a dramatic fall in their standard of living.
- May increase the incentive to find work.

The Government Capital Budget

Government Capital Budget: Outlines the governments planned expenditure on items not used up during the year but which increase the productive capacity of the country

The National Debt

The National Debt: This is the total amount of outstanding borrowing by the government.

Problems Associated with the Irish National Debt

1) **Opportunity Costs Involved:** With more funds being used to meet our annual interest repayments the government has less funds available for other purposes.
2) **Increased Burden on Taxpayers:** The increase will mean that the government will have to consider increasing future taxes for taxpayers.
3) **Increased Annual Interest Repayments:** An increasing national debt means that the annual cost of repaying our national debt is rising.
4) **Diminished international Credit-Rating:** The fact that Ireland is seen to have an increasing national debt means that our credit-rating is deteriorating.
5) **Euro Stability Pact Requirements:** Ireland has difficulty in meeting the conditions of the stability pact and hence corrective action must be taken in economic policy matters and agreed by the EU.
6) **Poor Management of Economy:** Some citizens may become aware of the government's poor management of the economy and this may diminish their confidence in the economy.
7) **Pressure on Government to Cut Spending:** Due to an increase in the national debt the government has cut back spending on certain public services, thereby affecting the provision of some services e.g. the health service; education service.
8) **Servicing the External Portion of the National Debt:** The external portion of the national debt is subject to exchange rate movements, if borrowed from outside the eurozone. The Irish Government doesn't earn tax revenue on the repayment of external sources, unlike on the repayment of internal sources.

Reasons For State Borrowing/Reasons for Increase in National Debt

1) **Increased Current Budget Deficits:** The government have decided to operate a deficit budget in order to continue with the provision of public services / not to further reduce aggregate demand. Any borrowing to finance this current expenditure will increase the size of the deficit. This money must be borrowed thereby increasing the national debt.
2) **Borrowing for Capital Purposes:** The government continues to borrow to invest in infrastructure and other capital projects, which will eventually generate income and yield tax revenues to meet costs of repaying the money borrowed (Self - Liquidating Debt). This also increases the national debt.
3) **Social Investment:** The government borrowed to invest in socially desirable projects which may not yield any tax revenue such as hospitals, schools, public amenities.

Economic Consequences of an Increase in the National Debt

Positive

1) **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.
2) **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.
3) **Future Economic Growth:** Increased National Debt may boost aggregate demand and may provide opportunities for further economic growth.
4) **Employment:** Rising aggregate demand should lead to increased demand for labour resulting in lower unemployment.
5) **Self-Liquidating Debt:** If the return on the borrowings is able to meet the cost of repayments then the borrowing has been self-liquidating.

Negative

1) **Opportunity Costs Involved:** With more funds being used to meet our annual interest repayments the government has less funds available for other purposes.
2) **Increased Burden on Taxpayers:** The increase will mean that the government will have to consider increasing future taxes on future taxpayers.

3) **Increased Annual Interest Repayments:** An increasing national debt means that the annual cost of repaying our national debt is rising.
4) **Diminished International Credit-Rating:** The fact that Ireland is seen to have an increasing national debt may mean that our credit-rating worsens.
5) **Outside Euro Stability Pact Requirements:** Ireland has difficulty in meeting the conditions of the stability pact and hence corrective action will need to be taken in economic policy matters.
6) **Poor Government Management of Economy:** Citizens may become aware of the government's poor management of the economy and this may diminish citizen's confidence in the government.
7) **Risk in Provision of Public Services:** Due to an increase in the national debt the government may cut back spending on public services, resulting in a deterioration in provision of services e.g. the health service

Benefits of Reducing the National Debt

1) **Reduced Annual Interest Repayments:** A declining national debt to GDP means that the annual cost of repaying our national debt is declining.
2) **More Funds Available to the Government for Current Use:** With less funds being used to meet our annual interest repayments the government has more funds available for use for other purposes.
3) **Reduced Burden on Future Taxpayers:** The decline will mean that the government will not have to contemplate increasing future taxes on future taxpayers.
4) **Improved International Credit-Rating:** Unlike other countries the fact that Ireland is seen to have a declining national debt as a percentage of GDP will mean that our credit-rating improves.
5) **Adhering to Requirements of the Euro stability pact:** Unlike other members of the Euro Ireland does not have a difficulty in meeting the conditions of the stability pact and hence no corrective action need to be taken in economic policy matters.
6) **Prudent Management of Economy by Government:** Citizens may be made aware that the government's management of the economy is prudent and this may boost morale.
7) **Possible Deterioration in Public Services:** If the reduced debt to GDP ratio is caused by a reduction in current borrowing the government

may spend less on public services resulting in a deterioration of these services i.e. the health service.

8) **Reduced Spending on Infrastructure:** If the reduced debt to GDP ratio is caused by a reduction in capital borrowing then there may be less spending on the state's infrastructure which may inhibit the future growth of the country.