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Chapter 24

The Government And The Economy - Fiscal Policy

'... in this world nothing can be said to be certain, except death and taxes.'
—Benjamin Franklin *(1706-90)*

Fiscal Policy: is defined as any action taken by the government which affects the size or composition of government revenue and expenditure.

24.1 The Current Budget and the Capital Budget

24.2 Deficit, Surplus and Neutral Budgets

The term **budget deficit** refers to the current budget. There is **never** a deficit in the capital budget.

A (current) budget deficit: is when government expenditure exceeds government revenue.
A budget deficit will have an inflationary effect on the economy.

A current budget surplus: is when government current revenue exceeds government current expenditure.

A balanced budget: is when government current revenue is equal to government current expenditure.

A neutral budget: is when the overall effect of the budget is neither inflationary nor deflationary.

24.3 The National Debt

The National Debt: is the total amount of money borrowed by the government which is still outstanding.

Domestic Debt: is that part of the national debt which is owed to Irih individuals and Irish financial institutions.

Foreign Debt: is that part of the national debt which is owed to individuals and financial institutions outside the country.

National Treasury Management Agency (NTMA): was founded in 1990 to borrow money for the exchequer and to manage national debt for the Department of Finance. In 2001 its functions widened to include management of the *National Pensions Reserve Fund*.

Is the National Debt a Burden?

1. **Self-Liquidating Projects**

   These are projects which will increase the future productive apacity of the country.

   Money spent on such projects does not constitute a burden.

   Deadweight debt: is borrowed money spent on loss-making projects or on items which yield little long-term benefit to the country.

   Deadweight debt does constitute a burden to the state.

2. **Infrastructure**

   Productive infrastructure: refers to state investment in those things which will directly increase output.

   E.g., roads, airports, etc.

   Such expenditure is self-liquidating since better infrastructure will increase the profitability of firms, resulting in increased tax revenue to the state.

   Social infrastructure: refers to the provision of services such as health, eduaction, housing, etc.

   Such expenditure is not self-liquidating directly, since no additional tax revenue accrues to the state. However, there is indirect benefit, since social infrastructure improves the productive capacity of workers.

3. **Private Sector Borrowing**

   If the government borrows funds which are not required by the private sector, then this does not represent a burden.

   However, if the government borrows funds which could have been put to better use by the private sector, then this does constitute a burden on the state.

4. **Interest**

   The greater the amount of national debt which is borrowed from abroad, the greater the financial burden on the government.

   In the case of domestic borrowing, any interest received by Irish individuals or institutions is liable to taxation as it is classed as income. In this way, the government can recoup a portion of the interest payments.

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5. **Borrowing for Current Purposes**

   Borrowing for current purposes represents the most serious form of deadweight debt. It is the problem which has blighted Ireland for the past number of years.

   Borrowing for current puposes does not always represent a burden. If such borrowing is undertaken to stimulate an economic recovery by increasing economic demand, then it is worthwhile. Note, however, that all such borrowing allows current consumption to be increased at the expense of future consumption.

24.4 Taxation

Characteristics of a Good Tax System

The Canons of Taxation:

1. **Equity**

   Tax rates should be fair: every person should pay according to his/her ability to pay. The more a person earns, the more tax he/she should pay. Note that this also implies that those at the bottom should also pay their fair share – this is not the case in Ireland at present.

2. **Certainty**

   Everyone should be able to work out his/her tax liability.

3. **Convenience**

   The payment of taxes should be convenient for the taxpayer.

4. **Economy**

   The cost of collecting tax should be small in comparison to the amount collected.

Further Characteristics:

1. **Redistribution**

   Taxation should enable the government to redistribute income form the rich to the poor.

   A progressive tax: is one that takes a higher percentage of income from the high-income earner than from the low-income earner.

   E.g., PAYE

   A regressive tax: is one that takes a higher percentage of income from the low-income earner than from the high-income earner.

   E.g., VAT

   A proportional tax: is one which takes the same percentage in tax from everyone.

   E.g., an income tax system with only one rate of tax.

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2. **Not Discourage Work**

   A good tax system should not be a disincentive to work. At present in Ireland marginal income tax rates are so high, and social welfare so generous, that there is no incentive to work.

3. **Not Discourage Investment**

   A good tax system should not discourage investment. Ireland's current corporation tax of 12.5% (and even below) is very important in attracting foreign direct investment.

4. **Act as an Automatic Stabiliser**

   A good tax system should have a stabilising effect on national income:

   (a) When incomes are rising, the amount collected in taxes should also rise, so that the increase in demand in the economy is curtailed. This will lessen inflationary pressures on the economy.

   (b) When incomes are falling, the amount collected in taxes should also fall, so that the decrease in demand in the economy is not as great as it would otherwise be. This will lessen deflationary pressures on the economy.

   Taxes are thus said to be *automatic stabilisers* in an economy, since they prevent incomes rising too fast in times of high demand, and prevent incomes falling too fast in times of low demand.

   In short, taxes can be used to attenuate the highs and lows of the *boom-bust cycle*.

Types of Taxes

1. **Direct Taxes**

   Taxes on income or wealth.

   (a) **Income tax:**
   Every individual who is employed is liable for income tax.

   (b) **Corporation tax:**
   A tax on company profits. (12.5%)

   (c) **Capital gains tax:**
   A tax levied on an individual if he/she sells an asset at a price higher than he/she purchased it.

   (d) **Capital acquisitions tax:**
   A tax on gifts or inheritances.

   Advantages of Direct Taxation:

   (a) Direct taxation conforms to all four 'Canons of Taxation'.

   (b) Direct taxes are automatic stabilisers.

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Disadvantages of Direct Taxation:

(a) High rates discourage workers from increasing their productive capacity by doing overtime, working longer hours, etc.

(b) High rates encourage tax avoidance and tax evasion.

(c) High rates encourage citizens to contribute to the *black economy.*

(d) High rates discourage investment.

(e) High rates penalise the most efficient companies.

2. **Indirect Taxes**

Taxes levied on goods and services.

(a) **Value-added tax (VAT):**
A tax levied at each point of exchange of goods and services, from primary production to final consumption.
21% standard rate; 12.5% reduced; zero rate on certain items.

(b) **Excise duties:**
These are taxes levied on goods which are produced for domestic consumption.

(c) **Customs duties:**
These are taxes on goods which are imported into the country.

(d) **Stamp duties:**
This is a form of taxation which involves the fixing of pre-paid stamps to legal and commercial documents.

(e) **Property tax:**
A tax paid to local corporations. Calculated as a percentage of the value of the dwelling.

(f) **Water tax:**
A tax (or charge) to pay for the provision of water supplies.

Advantages of Indirect Taxation:

(a) Cost of collection is low – *economy*;

(b) Harder to evade indirect tax than direct tax;

(c) Do not discourage work;

(d) Can be used by the government to encourage or discourage consumotion of certain goods and services, for instance cigarettes;

(e) Act as an automatic stabiliser;

(f) Convenient for the tax-payer as they are ‘hidden taxes’.

Disadvantages of Indirect Taxation:

(a) Inflationary;

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(b) Levied on goods and services consumed in equal quantities by rich and poor – *regressive*;

(c) Do not conform to the principle of equity;

(d) It is not possible for the government to predict accurately the yield from indirect taxation – an increase in indirect tax on a particular good may cause consumers to refrain from consumption, or switch to alternative goods.

The impact of a tax: refers to the individual, company, good or service on which the tax was initially levied.

The incidence of a tax: refers to the individual, company, good or service on which the tax eventually rests.

Example: if the government raises VAT by 1%, shopkeepers may raise their prices concomitantly. In this case the impact of the tax is the shopkeeper; the incidence is the consumer.

24.5 Semi-State Bodies

Semi-State Bodies: are state-owned enterprises which are involved in the provision of a wide range of goods and services to the public.

E.g. RTÉ, An Post, CIE.

If the provision of a particular good or service is not profitable no private firms will satisfy the demand – the government must step into the breach by using a semi-state body.

Explanations of expansionary fiscal policy, contractionary fiscal policy and neutral fiscal policy and limitations of fiscal policy to stabilise business cycles can be found in sections 23.5 and 23.6.

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