Introduction to the Irish economy: Fiscal Policy

This note will cover the following:

- Fiscal policy
- Expansionary fiscal policy
- Contractionary fiscal policy
- Automatic stabilisers

What is fiscal policy?

Fiscal policy refers to the government's choices when adjusting its tax and spending policies. Monetary policy is a set of tools the central bank uses to control the overall money supply, e.g., higher interest rates. Both monetary and fiscal policies are used to regulate economic activity over time. Governments typically use fiscal policy to promote strong and sustainable growth and reduce poverty[1].

If the economy is struggling, the government can increase the amount of money it spends to create economic activity, this is referred to as stimulus spending.

If there are not enough government income to pay for increased spending, the government may borrow money by issuing debt securities (e.g., bonds). This process requires accumulating debt and is referred to as deficit spending.

A fiscal policy response ultimately depends on four things:

1. Fiscal space[2] – the government has resources for new spending initiatives or tax cuts.
2. Issue debt – The government may sell debt (e.g., bonds) and fund projects through their sale.
3. Reallocate existing resources – The government changes existing spending to fund new polices or programmes.
4. Raise or lower taxes e.g. reduced VAT rate

Expansionary Fiscal Policy:

Expansionary fiscal policy is designed to encourage economic growth. The basic objective of expansionary policy is to boost aggregate demand,[3] and increase business investment and consumer spending by introducing more money into the economy.

The government can increase spending during expansionary periods to boost demand and stimulate economic growth. The government can also reduce taxes to put more money in consumers' pockets and encourage spending. Governments can also increase household income by increasing transfer payments such as welfare, unemployment, or other benefits.

1 IMF (2023) Governments use spending and taxing powers to promote stable and sustainable growth

2 Fiscal space is the room in a government´s budget that allows it to provide resources for a desired purpose without jeopardizing the sustainability of its fiscal position or the stability of the economy.

3 Aggregate Demand: is total amount of demand for all goods and services produced in an economy.

Contractionary fiscal policy:

Contractionary fiscal policy is the opposite of expansionary policy. In this case, the government either cuts spending or raises taxes. This reduces the amount of money available for businesses and consumers to spend. Policymakers take this action when the economy is perceived to be overheating and needs to cool down. A government may also cut spending or raise taxes to combat rising inflation. It should be noted, a government may be forced to contract fiscal policy if there is a fall in government resources to fund spending, such as in a recession.

Automatic stabilisers:

Automatic stabilisers are mechanisms built into government budgets, with a change in policy, that increase spending or decrease taxes when the economy slows. **Automatic stabilisers act to offset fluctuations in a country's economic cycle**. They are called this because they stabilise economic cycles and are automatically triggered without additional government action. Automatic stabilisers are a type of fiscal policy designed to offset fluctuations in the business cycle e.g. increased unemployment payments when employment falls[4].

Ireland's membership of the EU comes with some fiscal rules[5], many of which are set out in the Stability and Growth Pact[6] and the Fiscal Compact[7]. These rules include aiming for a government debt-to-GDP ratio of below 60% and limiting the size of the deficit that any government can run per year to 3% of GDP[8]. These rules directly impact the level of fiscal policy the government can take during an economic cycle. It should be noted that these fiscal rules were suspended to help countries deal with the Covid-19 pandemic and there is ongoing discussion about proposed changes to the rules[9].

4 Investopedia (2023) Expansionary Fiscal Policy: Risks and Examples

5 These fiscal rules are a long-lasting constraint on fiscal policy through numerical limits on budgetary aggregates. Fiscal policy is the change in government spending or tax brackets.

6 The Stability and Growth Pact only applies to EU countries

7 The Fiscal Compact only applies to the Eurozone and certain other EU countries which have opted in

8 Parliamentary Budget Office (2023) PBO Note on Proposed new EU Fiscal Rules (EU Economic Governance Framework)

9 Ibid