

Expansionary fiscal contraction in ireland in the 1980s essay sample



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Abstract

Fiscal policy is a policy that was stressed by the Keynesian approach when a country wants to have a stable economy. A country that wants to gain economic stability may use the Keynesian approach or can also use the Monetarist approach whereby this approach stresses for monetary policy. It is important to note the difference between the two approaches and the policies that they advocate for to understand the cause of this study. There is a clear distinctive difference between the two policies and the two approaches, however they are both unified by the fact that they need to stabilize another unstable economy. They are also both concerned about a country's government decisions about monetary spending and other issues like taxation and spending and the control of cash flow in a country. It involves various government institutes key among them being the central bank of any country (Nancy, 1989).

The difference between monetary policy and fiscal policy is that fiscal policy is concerned about the supply of money which the government can do so by controlling the amount of money in circulation while fiscal policy requires the government to change their stand on decisions about the government spending and taxation (Scott, 2000).

Expansionary fiscal policy is whereby a government decides to increase its spending, that is, increasing purchases that the government makes. It also involves the government enlarging the margins of its transfer payments and decreasing the taxation rates imposed on its citizens (Pill, 2004).

Fiscal policy

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As we have seen in the abstract, fiscal policy is an endeavor for the government to stabilize an otherwise unstable economy. There are different approaches that the government can make to realize a stable economy. These approaches can either be used individually, as a group or all of them can be employed at a particular time. Some of the approaches used are; a government can increase its spending in the economy, it can increase its payment of transfer-payments or it can reduce the taxes that are subjected to its citizens (Becker, 1991).

There exists an economical term known as “ contractionary fiscal policy” which is a negative aspect of the fiscal policy and whose immediate opposite is expansionary fiscal policy. Contractionary fiscal policy is where the government decreases its spending decrease its payments of transfer-payments and increase the taxation rate. This is meant to keep in control an economy that is overheated (Pill, 2004).

The major objective of the any fiscal policy is to manipulate the aggregate demand in an economy so that it can either cool down or increase to boost a recessing economy. A good example is that during a boom, the tax collection increases automatically while during a recession, transfer payments are increased so as to improve on the levels of national income. In the same respect an expansionary fiscal policy will have the government increase its payments of transfer-payments during recession and reduce the collection of tax during a recession. The whole idea behind a fiscal policy is to monitor and manipulate the national income and this can only be done by manipulating the aggregate demand in any given economy (Scott, 2000).

An important aspect of the expansionary fiscal policy is the inclusion of a multiplier effect hypothesis. This is used to determine by how much the government should increase or decrease its payments of transfer-payments, collection of tax and the government spending. It is used by economists to determine by what margin a government increase in its spending will have on the national income.

Keynes concentrated on the aggregate demand effects of a reduce tax imposed on the citizens. However, there are other economists who opted to concentrate on the supply side. Their studies became very popular in the 1980s because they argued that tax reduction tended to stimulate people to work more and hence resulted in increased production. More production meant increased tax revenues and an increased national income hence a better and improving gross domestic product (Nancy, 1989).

Fiscal policy has some disadvantages because some scholars have pointed out that it is usually not flexible and cannot contain various approaches at the same time. Others have said that it can be manipulated politically. The time lag between governments coming to a decision between cutting the tax and increasing government spending also suggests that it can occur counter-cyclically in its implementation stages. Those who prefer monetary policy also argue that fiscal policy is capable of discouraging private investment. In accordance, classical economists argue that wages and prices readjust themselves quickly and automatically to stabilize an economy and hence government intervention is really not necessary. Other economic models argue that consumers are capable of interpreting an increased government spending or tax cuts to mean hard times in the future when the move is <https://assignbuster.com/expansionary-fiscal-contraction-in-ireland-in-the-1980s-essay-sample/>

reiterated and hence control their spending as well. All the above can be said to come to the same conclusion that whether the government employs expansionary fiscal policy or contractionary fiscal policy, the national income does change in any way but they help in stabilizing an economy.

Expansionary fiscal contraction: Case study Ireland in 1980s

In a rare deviation from the normal, Ireland in the 1980s defied the Keynesian model and in fact seemed to have witnessed the reverse of the Keynesian model. Economic theory tends to be leaning on the believe that fiscal contractions slows a country's economic growth, there have been a few instances where the opposite could have happened and this is especially true to Ireland a few decades ago. This is because the mechanisms responsible fro reversing the Keynesian logic is the country's ability to maintain a long-term effect on the public finances. This stimulates the citizens' confidence and hence creates an atmosphere where the citizens are almost certain that times will change in the future and hence control their spending in accordance (Pill, 2004).

The Irish economy had great times from the year 1987 to 1990 and many scholars believe that an expansionary fiscal contraction was the root of this incredible growth. We have already seen that in a standard Keynesian model, the government will increase its expenditure to lead to an increased aggregate demand. However, the reverse can also happen and has happened in the past especially to the Irish economy in the 1980s. However, for the reverse to happen, it is necessary for an economy not to have huge debts and or those that have huge deficits in their budgets. This is because

people expectations can not be ignored and should be taken into account too (Scott, 2000).

Ireland's experience

Ireland was faced with a persistent inflation during the mid-1980s. This resulted in the country's industry facing high costs and the citizens faced with an inevitable unemployment which would be projected for a long-term period. The decade had been very depressing to the economy and most of their budget deficits which huge were financed through borrowing. There were not hopes of the future being ridden with surpluses and so economists had their own doubts about the working of any fiscal policy to salvage the country from a worsening recession (Pill, 2004).

However, in 1987, the Fianna Fail party took over the power from a coalition which was headed by the Fine Gael party. They did not have an overly conclusive majority support so they were dependent on support of the Independents. When they took over power they were faced with the difficulties that the Irish pound devalued in 1986 against the Deutsch Mark of Germany in the European Exchange Rate Mechanism. It had been devalued so that it could continue to trade competitively with its trading partner, the United Kingdom when the United Kingdom pound had depreciated in the same year. The government first major challenge was to come up with the 1987 budget which was a difficult challenge because it had to address the Publics' borrowing and spending predicaments. It initially had to rely on the proposals that had been left to by the preceding government (Nancy, 1989).

That budget was based on three basic principals that stipulated that the targets set for public finance had to be consistent, which would be overseen by the economy being managed well. It also had the principal that national borrowing and national debt servicing were to be significantly lowered and focus on economy productivity and job creation had to be paramount. In the end, the budget was piloted by the principals of a well managed economy which oversaw public finance targets consistence and the reduction in borrowing and national debt servicing.

Finally, the outcome was by far more fulfilling that what was expected. The budget deficit was lowered in significant rates and the trend continued for the next two years. In the year 1989 the budget deficit was just a mere 2%. The only predicament the Irish economy faced with the decrease in wages growth from the year 1987 to the year 1988. More significantly, the wages in her trading partners were steeply growing and this meant that compared to Britain, the cost competitiveness of Ireland had gained 3% (Pill, 2004).

The monetary policy had the goal of stabilizing and strengthening the Irish pound. Due to the 1987 budget, the markets expected that the new government had no intention of employing an expansionary inflationary in future, which forced the markets to be confident in the economy which led to 5% drop in the interest rates in the same year. The inflation in the prices for the consumers also dropped by 3. 2%, which the highest since the year 1960. Ireland was so effective that even during an unfair global economy year; the interest rates dropped another percentage in the following year (Becker, 1991).

Economic effects

The economic policies that were adapted by the government had tremendous effects on the economy. The fusion of price competitiveness and the masses and market confidence, an overwhelming impetus for the growth of the economy was witnessed. During the year 1987, outward growth was more intensified and this led to the industrial and export earnings expanding by a degree of double units. There was also improvement of domestic banking liquidity which was brought about by an important rising in reserves during the years 1987 and 1988. There was also a marked improvement in the private sector which boasted of an increase of 4.7% to 13.5% from the year 1987 to the year 1988 (Scott, 2000).

However, the stabilization was accompanied by a fall in real interest rates which subjected citizens to double policy shocks. One was the income effect which was brought about by a cut in the income that is considered to be disposable to consumers and firms. This cut was brought about by the fiscal contraction policy. Another one was the wealth effect which was brought about the unexpected decrease in real and nominal interest rates (Becker, 1991).

However, there was witnessed an increase in private consumption because households had to decrease their savings ration, thanks to the low interest rates. This also brought about an increased investment which was at 10% in the year 1989. The promising economic climate affected the GDP in a positive not and it also enhanced the government's triumph in achieving its set national and public finance debt servicing goals. This was facilitated by

the reduced interest rates. In addition, transfer payments were also lowered because the private sector needed more labor which was because they faced a huge demand from the domestic market and there was also an increased domestic investment. There was also the issue of increased indirect taxes that arose and benefited from the improved economy. There was also the improvement on the sales of high price commodities like cars which greatly influenced and improved the tax base of the entire economy (Pill, 2004).

Factors that led to Ireland success since 1987

One of the most important factors was that the Charles Haughey's Fianna Fail government was also supported by the opposition Fine Gael. With this support the government was confident enough to consolidate both fiscal and monetary policies. This ensured that the government lowered its spending, lowered its borrowing and also cut the taxes. The plummeting interest rates helped the economy by stimulating it (Nancy, 1989).

The tax cuts were a very important and useful aspect of the social partnership. This is because unlike the Britain government where the government decisively were against corporatism, the Irish government opted for a social dialogue in 1987 where the trade unions agreed for wage cuts in return of more influential policy and cuts on taxes. Today the social dialogue is still praised in Ireland and its immense advantages (Pill, 2004).

In England there was a ready supply of highly skilled and educated workers which included business-school graduates, engineers and scientists. Back in the 1960s there was a heavy investing by the government in education

which included higher education and secondary education. The Irish
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universities were very useful to the investments in the country which included pharmaceutical and health care companies. The education investment was spread all over the country so a company could set up anywhere and be assured of enough skilled labor (Pill, 2004).

Prior to 1987, there was a witnessed high tax rate in the country which was a great burden to the people of Ireland. This acted as a deterrence to domestic growth but after the Fianna Fail party took over, there was witnessed the government lowering income-tax rates and this can be said to be the key miracle that ever happened to the Irish people.

The biggest contribution to the Irish success is that there were more people working in the country. After 1980, the women participation in the workforce improved significantly and this led to the women workforce attaining the international level which had not been witnessed before. Before 1987, there was a very distressing percentage of unemployment within the Ireland country which after 1987 improved dramatically (Nancy, 1989).

Other possible options

As the study has shown, a government effort to stabilize an economy can be done either by fiscal or monetary policies. If the Irish government had adopted a monetary policy instead of a fiscal policy, the changes that would have to be made would include controlling the supply of money in the economy. This would have been delegated to a central bank. It is important to note that central banks are either partially or fully independent of the government. The central bank would have been left to the task of controlling the money supplies whereas the government would have done nothing or <https://assignbuster.com/expansionary-fiscal-contraction-in-ireland-in-the-1980s-essay-sample/>

very little to help in stabilizing the economy. The central bank usually relies on the inflation as an indicator of stability of the economy. A central bank's options are limited because in case of an overheated economy the only option is to damp the activities of the economy. This is done by selling government bonds to the citizens who in this case. In so doing it would have to sell the bonds in low prices and at an open market. But we also have to question and put into consideration if an intelligent population opts to keep their money instead of buying the government bond. Sometimes central banks still dampen the economy by raising interest rates which makes the cost of capital to raise (Becker, 1991).

Recommendations

The study would recommend that should the government feel that they need to be stabilizing an economy which is in recession, it would be better if the government used the fiscal policy unlike using the monetary approach. In the fiscal policy, the government is at a more influential position than in a monetary policy because the government must have left all the responsibility with the central bank. The government is at a better place to handle a receding economy because it has its various mechanisms and systematics that it can employ to create a more stable government than the central bank.

The reason for this is because the government is more capable of bringing in the most important investors by enticing them with policies of tax cuts, interest rates, free market and price competitiveness, which the government in this case fully employed in Ireland from the year 1987. However, in the

case of a country that has high budget deficits and huge international loans, the best option for the government is the monetary policy, which is more capable of influencing changes in money supply and demand, thus influencing interests which can easily raise the government's chances of reaching the target in terms of public finances and public loans repayment.

In the case study of Irish economical triumphs of the 1980s the government employed a combination of both fiscal and monetary policies although the most outstanding one was the fiscal policy. This ensured the government's success in stabilizing the economy and some of the benefits were reduced budget deficits, reduced international loans, increased domestic investment and also improved employment rates (Scott, 2000).

Conclusion

In the study, we have come to the conclusion that though fiscal policy is expected to work in a certain direction in terms of cooling and boosting an economy according to Keynesian Models of economy, this does not always work and in fact a reverse of the expectation can be achieved. This is because we should not ignore the people who have their independent expectations and cannot react in the other way rather than how they are expected to react by the government (Nancy, 1989).

We have also come to the conclusion that fiscal policy is more advantageous in some circumstances over the monetary policy, but it is all dependent on how well the government employs the policies and what approach they take. It also depends on the extent of the loans and budget deficits the economy

has and one policy may work better than the other policy in a given situation.

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