Economics of Government Borrowing

**Government Borrowing and the National Debt**

*Budget Balance = Tax revenues - Total Government Spending, £ billion*

Key definitions and figures

- The **budget deficit** is the annual difference between government spending and tax revenues.
- The UK government has run a budget deficit in each of the last six years and in 2007-08 it amounted to £40bn (or just over 3% of GDP).
- The **national debt** is the accumulated government debt that has not yet been repaid.
- In 2007, the UK national debt rose above £500bn for the first time and is forecast to rise above 43% of GDP this year because of the extra debt the government has taken on with the nationalisation of Northern Rock.
- The Chancellor has two ‘self-imposed’ **fiscal rules** concerning borrowing. One is the ‘golden rule’ that government spending on currently provided goods and services should be financed by taxation over the course of the economic cycle. Government capital spending (public sector investment) can be financed by borrowing because it results in the accumulation of capital which has long term economic benefits for the country.
- The second rule is the **sustainable investment rule** which says that national debt should be held as close to 40% of GDP as possible.

Source: Reuters EcoWin
Volatility and problems in forecasting government borrowing

The budget deficit is the difference between two huge numbers and it doesn’t take much of an error in either of them for the budget deficit to change significantly.

The amount that the government borrows is very sensitive to the economic cycle. On some estimates, for every 1% change in the UK’s real GDP, the budget balance changes by £10bn. So a recession in 2008-09 could have a dramatic effect on the Chancellor’s forecasts for government borrowing

Government borrowing and demand management

- **Discretionary fiscal changes** are deliberate changes in government taxation / spending / borrowing – for example a decision by the government to increase total capital spending on the road building budget or increase the allocation of resources going direct into the NHS.

- **Automatic fiscal changes** are changes in tax revenues and state spending arising automatically as the economy moves through different stages of the business cycle. These changes are also known as the automatic stabilisers of fiscal policy e.g. during a slowdown or a recession, the government normally ends up running a larger budget deficit.

Estimates from economists at the OECD have found that the effects of the automatic stabilisers of fiscal policy can reduce the volatility of the economic cycle by up to 20%.

- **A reflationary fiscal stance** happens when the government is running a large deficit budget (i.e. G>T). Loosening the fiscal stance means the government borrows money to inject funds into the economy so as to increase the level of aggregate demand and economic activity.

- **A deflationary fiscal stance** happens when the government runs a budget surplus (i.e. G<T). The government is injecting fewer funds into the economy than it is withdrawing through taxes. The level of aggregate demand and economic activity falls.

Financing government borrowing

1. The government finances a deficit through the issue of government debt (securities)
2. Debt sale / issue is handled by the debt management office of the Bank of England
3. The government can borrow short term through the issue of Treasury Bills
4. Or it can borrow long term through the sale of Government bonds
5. Bonds are typically for between 3 and 10 years although “longer-dated” securities are also issued

Economic arguments supporting an increase in government borrowing

There are many sound arguments for the government to borrow – providing that such borrowing brings economic and social benefits – here are some of the arguments:

1. **Shock absorber**: A short term rise in the budget deficit might be caused by external shocks (e.g. the credit crunch) which will unwind at later stages of the economic cycle when the economy recovers
2. **Demand management is very useful**: A rise in government borrowing helps to stabilise aggregate demand during a downturn (i.e. it is a form of Keynesian active demand management) – an important tool of “counter-cyclical” macro-policy especially if monetary policy has become less effective
3. **LRAS:** Borrowing to finance extra capital investment is perfectly legitimate – because it adds to the economy’s stock of capital and can support long-term growth (i.e. an increase in LRAS) – the economy benefits in the long term from investment in schools, hospitals and critical infrastructure.

4. **Self-financing borrowing?** Some government borrowing is self-financing if it leads to a rise in economic activity, higher employment and a future increase in tax revenues

5. **Tap into overseas savings:** Government debt is currently low, expressed as a percentage of GDP – so there is plenty of scope for higher borrowing without any upward pressure on interest rates – the UK government rarely has a problem finding people to buy their debt especially as our economy is open to capital flows from overseas.

**Counter-arguments – concerns over the size of government borrowing in the UK**

1. **Crowding-out:** Extra government borrowing can push up long-term rates of interest and therefore create some “crowding-out effects” on the private sector of the economy – higher interest rates might damage consumer spending, business confidence and capital spending

2. **Debt burdens:** Higher government borrowing today adds to the accumulated national debt which increases the future interest payments on this debt (this involves an opportunity cost) and is a burden on future generations of taxpayers

3. **Taxing teenagers:** There are inter-generational equity issues involved with rising and persistent budget deficits – one principle is that each generation should meet the costs of the benefits they derive from current government spending – today’s teenagers will be paying higher taxes because of excessive borrowing by the state

4. **Rising tax burden:** Increased government borrowing may eventually require higher taxation to fund it again this raises equity issues and may causes some “crowding-out” e.g. higher income taxes cuts into our disposable incomes and higher business taxes may reduce investment and employment in the economy – threatening competitiveness

5. **Might stoke up inflation:** Too much borrowing risks creating demand-pull inflationary pressures (this depends on other factors though)

6. **Waste?** There are concerns about the social return from extra public spending – how much actually goes into improving public services? Is too much state sector spending wasted?

**GBR’s evaluation points:**

A. Government borrowing had demand and supply-side effects (use AD-AS diagrams to show this)

B. Borrowing to finance essential (critical) infrastructure is vital for our long run health

C. Possible for both the private and public sector to do this investment jointly (e.g. PFI projects)

D. The government’s fiscal rules have lost most of their credibility partly because of frequent fudging by the Treasury about start and end points for the economic cycle

E. For the government to be borrowing £40bn + 16 years into a recovery is a worrying sign – “mend the roof when the sun is shining”

F. Tax burden is now rising …. Threatening foreign direct investment and other aspects of the supply-side of the UK economy

G. But there is a case for using fiscal policy / borrowing to actively manage AD as part of a broad strategy and when monetary policy has lost some of its impact

H. Monetary and fiscal policy does not operate in isolation