Funding the Future

We can afford public sector pay rises and don't need to...

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It seems [that there is almost universal political agreement]now that the UK's public servants deserve a serious pay rise after seven years of real pay cuts. But, having achieved that goal another, quite extraordinary, discussion has arisen, which is on how we, a a country, are going to pay for this apparent profligacy. It is as if the logic is that if nurses want an additional one per cent then one in hundred of them mist be sacked or as MP after commentator has said "we'll be passing the burden to our children to pay the debt".

This is utter nonsense. I want to give three practical factors that are being ignored by those commenting and then move on to the reason why what they're saying is economically illogical.

The first issue being ignored is the fact that tax is paid on these pay rises. Everyone knows this, of course, but it is as if even the IFS resorts to the household / small business analogy of economic analysis by ignoring this fact. Of course when a business pays over the tax due on a pay rise that's a cost. But that is not the case for government: it is paying itself. And since on average we pay 39% in tax overall that means that at most only 61% of these pay rises need to be paid for because the rest is paid by the recipients in extra tax. Bizarrely, no one seem to be saying this. I have no idea why.

The second practical issue is that once the first recipient of this pay rise has paid their tax they will then spend the vast majority of what they have left over. And those recipients then pay tax. And this extra tax then goes back to the government. And so, on and on. This is a geometric progression: the fact is that the increase in government spending that these pay rises represent eventually comes back to the government in extra tax paid. It does not happen overnight of course, but it happens. In other words, over time the increases pay for themselves.

The third practical factor that is being ignored is that paying more to people who have earned it has a wider impact on the economy. It boosts confidence. It increases spending. And both stimulate markets that are, let's be honest, pretty much in the doldrums right now. So this encourages an increase in investment. And that increases employment. And so more tax is paid. And then the economy grows. And so more tax is paid. In other words, the additional revenue resulting from the initial spend may not just be that which can be seen to directly flow from it. If the spend takes place in a market operating at less than full capacity (and that's a fair description of the UK) then there is what is called a multiplier effect because the increase in economic activity resulting from the sum spent is greater than that spend. The result is obvious: over time the spend may actually more than pay for itself in additional yield as far as the government is concerned. But again, no one is saying that, and I have no idea why.

In this case for three wholly practical and economically sound reasons this spending may pay for itself and there is no reason to increase taxes to pay for it, and there is also no reason at all to discuss it creating a debt burden. But then let me get to the real reason why this is the case. The fact is, as often discussed on this blog, tax does not in any case pay for government spending. It never has, and it never will.

All government spending is paid for out of newly created money. This is not made by physically printing it of course, although it is worth recalling that the government's ability to print and mint money does prove its right to do so. Instead this new money is created electronically. It happens like this. When the government spends it does in effect borrow the cash from the Bank of England. This is a straightforward thing to do. What it means is that the Bank of England extends it the credit. And what that means is that the Bank of England simply marks in its ledger (using a computer keyboard) that the government now owes it more money. It does not go and see if it has the cash in question: it does not need to. All it does is say it owes it more, and that is it. No one else's money involved because the credit in question is new. But given that all money is just a promise to pay (read a bank note to prove that) and promises to pay are just a way of recording credit then that is all that is required.

And there is nothing unusual about this. If you extend an overdraft exactly the same thing happens. The bank you borrow from does not first of all check it has someone else's money to lend to you; it does instead simply create the money you borrow by marking up your account. That is how banking works. Banking is not a process of taking in some people's money and lending it out again. That may be what the historic economic textbooks say, but even the bank of England has said those books are wrong. It is just a system where credit is extended in a special way, because this credit can itself be spent.

Of course, money creation can't go on forever though, and it doesn't. In the case of your bank borrowing the money that the bank created for you is cancelled and disappears forever when you repay the loan. It's as simple as that. Your promise to pay made the money. Your repayment destroyed it again.

In the case of the government the money that the Bank of England creates for it so that it can spend is is cancelled in a different way: tax paid does that. So, tax does not pay for government spending in that case. What it does is cancel the money created to pay for that spending.

This is important for two reasons. First, it means extra tax is not need to pay for the public sector pay rise because it cannot pay for it: it's always going to be paid for by the government borrowing more. But second, because the new money that pays for the pay rise is now available to be taxed - precisely because the pay rise did itself make it available for that purpose - it is always going to be true that so long as there isn't full employment (when new money creates inflation) that the pay rise will pay for itself using one or all of the mechanisms noted above. The pay rise does itself create the new money needed to pay for the tax payment to cancel the money that was created to make the additional payment to public servants in the first place. And yes that's a circular argument because that is the way the world is. The trouble is that there are those who think public sector pay is poured into a black pit from which it never emerges again, and that is the fallacy. Mine is the correct representation, I suggest/

But it does have to be asked where borrowing come into all this? This needs to be mentioned because otherwise it will be asked by others. First, note that government borrowing is normal and has to happen. It is the only way it creates our money. If money is a promise to pay (and it is, because it cannot be anything else) then unless the government spends ahead of taxing and so owes the economy there is no money in circulation. Cancelling the national debt would, then, cancel all government created money - the pound in your pocket. That is a pretty uncomfortable prospect. So we need government debt. And a growing economy - whether growing through real economic activity increasing or because of the inflation we need - needs more money. But there is slightly more to it than that. Growing debt is a function of that growing economy. What it simply says is that the government is injecting more money into the economy and has simply not yet reclaimed it. That's all the national debt it.

This then is a measure of good government: the government acting responsibly to create the growth we want.

And it is simply a measure of the mount of money the government has injected into the economy for others to use - which we all need if the economy is to keep revolving.

And on the way, by packaging this as a special form of savings account - called gilts - the government uses it to provide a form of safe savings mechanism to people who need, including banks themselves and pensions funds, neither of which can operate without national debt and both of whom do, if anything need more of it.

So will we have to repay the debt? The answer is no, of course we will not. Firstly that is because we have never repaid the national debt. Second, that is because we not only know we do not need to do so, but know that it would be calamitous to do so: there would be no more money. Third, it's because the idea of repaying the national debt is absurd: we can only do so by over-taxing and so shrinking the economy for the sole reason of denying the money markets a product that is critical to their operation. Fourth, we know that if we did want to repay the debt we could do so tomorrow and costlessly: £435 billion of QE has proved that. In that case we keep it for good reason. In all these cases then saying we are passing on a burden to the next generation is absurd, unless, of course, you think passing on money to them is crazy, because that is what the national debt is.

So can we afford to give public sector staff a pay rise? Of course we can.

All we cannot afford is the hardship not doing so will cause and which wholly flawed economics is imposing on us.