Funding the Future

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*I am proposing to post this explanation of the nature of national debt in this blog's glossary once comments upon it have been made. I might also try to do a shorter form version once comments have been made:*

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National debt is one of the most difficult concepts to understand within economics, not least because there is a very good argument that it does not exist, at least as it is commonly understood in countries like the UK.

A country's national debt as conventionally described in a country like the UK, where the whole of the sum described as such is denominated in the fiat currency that is the legal tender of that jurisdiction, is the cumulative difference between the money expended by a government using the funds created for its use by its own central bank over a period of time (usually considered to have started in 1694 in the case if the UK [1]) *and the net taxation revenues that it has generated over that same period.*

*This definition of the UK's national debt represents an accounting identity given the facts noted, i.e. it has to be true. The money created by the UK's central bank (the Bank of England) for the government that it serves is either in existence or it does not. There is no other possible state that the money in question might have.*

*Money created by a central bank for the government it serves always ceases to exist when tax is paid. The cancellation of money created as a result of government expenditure is, as a consequence, the primary purpose of taxation. It follows that taxation does not fund government expenditure. It does instead cancel the money created as a consequence of that expenditure taking place as a means of controlling inflation.*

*It is neither necessary, let alone always possible, for a government to collect tax revenues equivalent to the sum that it spends into its economy during a period. There are several reasons for this:*

* *The government in question might wish to leave some part of the money that it*

*creates in circulation within the economy because doing so provides that economy with the base liquidity, or money supply, required to ensure that transactions in the fiat currency that it has declared to be the legal tender of the jurisdiction can take place.*
* *The government might wish to stimulate the economy for which it is responsible as a consequence of the fiscal policy that it has adopted, which means that it must leave part of the sums it has expended into the economy uncollected by way of tax charged.*
* *Leaving a part of that expenditure uncollected in the economy means that the balance in question can be re-deposited with it in savings mechanisms of various forms. The government's ability to vary the rate of interest paid on those savings mechanisms that it makes available provides it with the means to influence interest rates in the economy as a whole as part of its overall economic strategy that combines both fiscal and monetary policy.*
* *The forecasting of taxation revenues is a decidedly imprecise art and is most definitely not a science. The level of tax paid in an economy can, for example, vary considerably as a result of exogenous shocks, such as the global financial crisis in 2008 and the covid crisis of 2020, both of which massively reduced taxation yields in the years in question.*
* *Levels of government expenditure can also vary in unplanned ways after taxation rates have been set, with 2008 and 2020 providing further evidence in this regard.*

*There are two possible responses that a government might make to the injection of money that it has had newly created on its behalf by its central bank that it does not plan to recover by way of tax charges. Those choices are that it might either:*

* *Leave the balance that it owes to its central bank for new money created to fund expenditure as outstanding on what would, in effect, be an overdraft facility with that central bank. This was quite commonplace in the UK until 2000, the account in question being called The Ways and Means account[2].*
* *Induce those persons still in possession of those funds in the private sector economy to deposit them with it on savings accounts of various forms. This has been the universal practice since 2008.*

*The most common types of savings accounts offered by the UK (and most similar) government for this purpose are:*

* *Bond or gilt accounts, where a sum is saved for a fixed period at a fixed rate of interest with redemption taking place on a predetermined date at either a fixed amount or at an amount that is increased depending upon the rate of inflation within the jurisdiction from the time of issue of the bond to the time of its redemption.*
* *Very short-term savings accounts that are usually described as treasury bills that are only of any real interest to professional participants in the financial markets of a jurisdiction.*
* *Savings accounts are of a type more commonly provided by commercial banks, including instant access or term deposit facilities. In the UK, these are described as National Savings and Investments (NS&I) accounts.*
* *Unconventional savings products, which in the UK are best represented by premium bonds.*

*Some of these products are more commonly considered to be government borrowing in*

*popular narratives, e.g. bonds and treasury bills tend to be referred to as government borrowing, whilst more conventional government-provided savings facilities such as NS&I accounts and unconventional savings products, such as premium bonds, tend to be thought of as savings accounts.*

*In reality, all these arrangements have a number of things in common:*

* *They are all intended to induce the deposit of what is, in effect, government-created money with government-backed savings agencies so that the government in question might then clear its apparent overdraft with its central bank that was created to facilitate government expenditure before taxation revenues were received, as always happens.*
* *All these balances are credits on the government's balance sheet. Such balances can either be considered to be liabilities, of which borrowing is a particular form, or they can be considered to be equity, i.e. sums without any fixed repayment date or obligation to pay a return.*
* *Because all of the savings accounts noted have an identifiable third party to whom a sum might eventually be payable, they can, correctly, be considered liabilities. This contrasts with any balance owed by the government to its own central bank, e.g., on its Ways and Means Account. Because that central bank is effectively a part of the government, there is no third party to whom liabilities are owed as a result, and as a consequence, any sum of money owed to that central bank by the government that controls it cannot be a liability but is, instead, a balance equivalent to equity capital. It should be added that since government-created money is spent into the economy via central bank reserve accounts, which are explained here, these balances are also equivalent to equity capital as they have no fixed repayment date, and there is no legal obligation to pay a return upon them, and none was until 2006.*
* *It follows that when a government chooses to induce people holding funds within its economy to save with it, with those sums saved effectively representing money created by it but not yet withdrawn from circulation as a consequence of taxation paid, it does, as a result, choose to substitute a liability on its balance sheet for capital on that same balance sheet. At the same time, it can be argued that it also chooses to accept a fixed obligation to a third party to make payment in compensation for their choice to hold funds with the government as opposed to having an arrangement where no such obligation exists.*

*The question that then arises is whether or not the decision by a government to voluntarily accept liability to third parties for sums that impose cost to their budgets can ever be an issue of economic concern within its overall microeconomic policy?*

*The obvious answer to this question is that this is not the case for three reasons. They are:*

* *Firstly, that those who have chosen to deposit funds with the government have done so voluntarily, knowing the terms on which they do so, also being aware that in the vast majority of cases repayment will not be due to them for a considerable period of time.*

*The risk profile within this liability is, as a consequence, inherently low because the vast majority of it will not be due for payment at any point in time.*

* *Secondly, the vast majority of those choosing to deposit funds with the government will do so precisely because they are aware that, unlike commercial banks and deposit takers, a government possessed of its own central bank and its own currency that is acceptable for exchange within its own economy can never run out of money to make repayment to a person to whom a liability is owing by it, precisely because it can always create the necessary money to make that repayment by simply issuing a demand to its central bank to make the payment in question.*
* *Thirdly, within very broad parameters, the rate of interest payable by a government on its borrowing is normally its to choose because its own central bank determines the base interest rate in use in that economy at any point of time, and that base rate has significant influence upon other interest rates in use in that economy, including those payable on sums deposited with its government.*

*Why, then, is there an obsession, mainly on the part of politicians, with the size of the national debt that a country might have, usually expressed as a proportion of its national income or gross domestic product?*

*There is no rational answer to this question unless the debt in question is denominated in a currency other than that of the jurisdiction itself. This is, of course, commonplace in the case of low-income countries and those states that are, for example, dependent upon funding from international financial organisations such as the World Bank, most of whose loans are denominated in US dollars.*

*In those situations, it is the case that the liability owed by a government can create real financial stress for its jurisdiction because it is duty-bound to then generate revenues in the currency in which its liabilities are due. That requires that it maintain a steady flow of exports from its jurisdiction that are not matched by imports of equivalent value, and that necessarily means that a drain is imposed upon consumption within that jurisdiction to service the debt in question, the interest on which will necessarily represent a transfer of well-being from the borrowing state to that institution or state that made the loan to it. It is entirely possible in this circumstance for a country to become over-leveraged, meaning that it has borrowings in excess of its capacity to service repayments and it can, as a result, default on its obligations. However, this situation cannot be extrapolated to a jurisdiction that has borrowings solely or almost entirely denominated in its own currency, which is the circumstance of the UK, as outlined above.*

*For reasons that appear to be entirely political, confusion between the situations of states in these very different positions has been created. The result has been that pressure has been brought to bear on countries whose only borrowing is denominated in their own currencies to reduce or at least moderate that borrowing, even though by doing so they might:*

* *Restrict the necessary new money supply, and so liquidity, that their economy*

*requires.*
* *Fail to undertake necessary expenditures to fulfil the demand for government services within their jurisdiction.*
* *Unnecessarily reduce economic growth within their jurisdiction, especially when the multiplier effects of government expenditure are taken into consideration.*

*These consequences do, however, explain the motivation for the imposition of the supposedly necessary limits on government borrowing in its own currency. The intention of those promoting such limits is to reduce the scale of government activity within a jurisdiction.*

*This is not to say, of course, that a government can, as a consequence, create money without limit. In practice, there are practical limits on a government's capacity to create money to fund expenditures, which are:*

* *Its ability to recover taxes due to it from the economy for which it is responsible. This ability is always constrained because no government has ever discovered a way to recover all sums owing in tax to it. The extent of that constraint is, however, to some degree under its own control, depending upon its willingness to invest in the tax authority that it gives the task of recovering sums owing to it.*
* *The ability of the government to induce people holding the currency that it has created within its own economy to save with it, which is necessarily constrained by the levels of interest that it thinks are appropriate to be used within that economy in combination with the economic, social and fiscal policy goals that it wishes to fulfil.*
* *The actual capacity of the economy for which a government is responsible to meet the demand that government creates for the supply of goods and services to it, which is a physical rather than a financial limitation.*
* *The exchange rate that a government wishes to maintain with other jurisdictions which can be impacted if it seeks to overinflate the scale of economic activity within its jurisdiction so that imports must be relied upon to meet the demand that a government creates.*

*These points, being noted, none of them alter the fact that:*

* *A government that only has liabilities owed to those who have deposited funds with it denominated in the currency that it has created cannot have a national debt but can only be the provider of deposit savings facilities to those who wish to make use of them.*
* *There can never be a risk that those deposit saving facilities will not be repaid precisely because the means of making that repayment are solely within the control of the government that created them, which is a characteristic shared by no other savings institution taking deposits in that currency.*
* *The interest payable on these deposits will, assuming that the physical limitations on the scale of government expenditure noted above are respected, always remain within the control of the government making them available, and those costs should never create a constraint upon its capacity to meet any other obligation as a result.*

*Seen in this way, a country like the UK does not, in fact, have a national debt. It does, instead, have a national savings bank or facility, which is a matter of considerable*

*benefit to the people of the country.*

*It also has national equity capital, which, in the case of the UK is at present broadly represented by those government bonds now owned by the government itself as a consequence of the operation of quantitative easing policies since 2008, and although this situation has been complicated by the decision of the UK government to make payment of interest on central bank reserve account balances that is another issue, not necessarily related to the supposed national debt as such.*

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***Endnotes***

***[1] See this article for an explanation as to the use of this date, which is when the UK's national debt is considered to have first been created. https://www.bankofengland.co.uk/freedom-of-information/2020/details-of-the-bank-of-england-loan-to-the-government-in-1694***

***[2] https://assets.publishing.service.gov.uk/media/623a22078fa8f540ecc60532/DMR_2022-23.pdf provides evidence that the mechanism still exists. It was temporarily expanded to £20 billion in April 2020. Its use was commonplace until cash flow management was moved from the Treasury to the government Debt Management Office in 2000 and was faded out after 2008. See https://www.dmo.gov.uk/media/10808/sa240108.pdf. The pretence that the current way of managing debt is normal is, as a result, wrong: it is a recent innovation.***