Funding the Future

Glossary entry: deficits and the national debt

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I have written a new glossary entry that covers both deficits and the national debt.

This is it. Comments are welcome.

A government deficit arises when a government spends more into an economy during a period than it extracts from that economy via taxation or other forms of income.

When this happens, the government creates additional money to meet its spending commitments, doing so via its central bank, which it both owns and controls in the case of a country like the United Kingdom.

The new money in question can be left outstanding as owed by the government to its central bank, or the government can issue bonds or gilts (as they are called in the case of the UK) to clear that balance it notionally owes to its central bank, which is the Bank of England in the case of the UK.

In either case, the cumulative deficit incurred is described as the national debt, although it does not, as such, represent borrowing.

That is because the sum owed by the government to its central bank is a balance that disappears if the activities of the two are consolidated, as is always technically possible in accounting terms (and accounting is what is being discussed here). Consolidation is what happens if a single set of accounts for the government as a whole is created. The asset of the central bank that the government owes to it is, in that case, matched by the liability the government owes to the central bank: there is, in net terms, no overall liability as a result.

In that case, the sums paid to the government for bonds that it issues do not clear the government's liabilities, because in net terms, it has none. Instead, they represent sums placed on deposit with it as if it were a bank.

As importantly, the sums placed on deposit can only exist because the government created them by spending more than it raised in revenue: the sums deposited represent the sums created by the government not as yet taxed back by it, but which it might claim back through additional tax, at its own discretion.

This arrangement is particularly advantageous to the wealthy of a jurisdiction that offers bonds to those who want to subscribe for them. Since to be able to subscribe for bonds a person must be possessed of private wealth, or represent those who do, and those with private wealth are invariably those most likely to be under-taxed in a jurisdiction simply because they have most income and wealth on which tax might be paid, the offer of bond deposit facilities means that the wealthy are compensated with the payment of interest on balances they deposit with a government that it could otherwise have demanded from them by way of payment of tax instead.

The result is that the value of bonds in issue can be seen as representing the value of the money supply the government has injected into an economy to permit it to function. This injection of money into an economy is a crucial role that a government must undertake. The supply of fiat currency is a fundamental task of modern governments. It is not a weakness of that system of government, but a strength. Withdrawing these funds from use by eliminating this supposed debt would mean that government-created money was no longer available for use in the economy of the jurisdiction in question, which most likely could not function without it. Those suggesting that national debt is a problem have, in that case, failed to understand what that debt is and why it is so important.

The real issues of concern with regard to the national debt are, in fact:

* Whether more tax should be charged to reduce inequality.

* Whether interest should be paid, and at what rate, to bondholders given that they crave the security of depositing funds with the government, which is the only institution in any jurisdiction able to guarantee repayment, come what may, since it alone has the power to create fiat money.

* Whether excess funds fuelling inflation are being created.

By itself, the quantum of the debt is not an issue.