A reader here has written in response to recent posts on how government spending works:

“Thanks, Richard, for the patient and insightful explanation. In my mind it leaves a question that keeps bugging me: when commercial banks make a loan, and the borrower spends it, it puts money into the economy. As the loan gets repaid, that money disappears from the accounts.

When a government spends, it seems, the money is taken out of circulation by tax.

BUT, is that money taken off the accounts by a similar process? It looks from your explanation that the money sloshes around in the central bank reserve account and can be put into circulation again by public spending?

I’d love to know which account actually cancels the spending, or to know that government spending increases the amount of money in the system perpetually.”

That's a good question, and it goes to the heart of why the government’s money is not like bank money. Let me break this down.

First, when commercial banks lend, they create new money, but only temporarily. A bank loan creates a bank deposit out of thin air, and then the moment the loan is repaid, that deposit vanishes again. Bank money is inherently self-cancelling.

Second, government-created money, or base money, is not of that kind. When a currency-issuing government spends, the Bank of England simply marks up the central bank reserve account of the bank that receives the payment. What appears is new net financial wealth for the private sector. In other words, someone's bank balance has been increased by the government making a payment, with that deposit being backed by their bank's reserves at the Bank of England.

Third, taxation reverses that process. It does not fund the government; instead, it erodes the purchasing power that the government previously created by spending new money into existence. When tax is paid, a commercial bank instructs the Bank of England to mark down its reserve balance. The commercial bank then reduces the taxpayer’s deposit accordingly. That money is gone. It does not sit in a pot. It does not fund the next round of spending. It is eliminated.

So yes, tax cancels government money — just as a loan repayment cancels bank money — but with one crucial difference. Government spending creates money that is not automatically cancelled again. It only disappears if and when tax is charged.

Fourth, the amount of money left in the economy after tax is a policy choice:

*
If a government spends more than it taxes, the private sector ends up with more net wealth.

*
If it taxes more relative to spending, private wealth is drained, and the economy is deflated as a result.

This is why the guilt trip about “balanced budgets” is so dangerous. The goal is not to balance the government’s books. The goal is to balance the whole economy.

So, lastly, what happens to those reserve balances? They do not fund anything. They are simply the central bank’s record of what the government has already spent into existence. They can always be increased again by spending, or reduced by tax. The constraint is never that the government runs out of reserves; it is whether adding more money would create inflation.

Taking all these factors into account, the answer to the question is this:

* Government money only disappears when the tax deletes it or it issues new gilts, which deletes it until said gilt is redeemed.
* If that does not happen, government spending permanently increases the money supply.
* And that is how every pound in your bank account ultimately began its life.

That’s not a flaw. It is the system working as designed.

And we should be honest about what follows, which is that so long as real resources, whether human or otherwise, are available in the economy, we can:

* Afford full employment.
* Afford fully funded public services.
* Afford to green the economy.

But what we cannot afford are the political myths that pretend the government is financially constrained like a household or a commercial bank.

The government’s job is to ensure we have enough money in the system to let everyone live, work and care without exceeding the limits of what the real economy can supply.

That is what real fiscal responsibility looks like.