Funding the Future

If you want to understand government finances don't ask...

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If we want to understand government finances, the last people we should ask are usually businesspeople and the City of London.

That might sound surprising. Businesspeople deal with money all day, whilst the City supposedly exists to understand finance. But neither seems to understand government finances.

The first problem is that businesspeople think in microeconomic terms. A business can spend its income, use existing cash or borrow. What it cannot do is create the money it needs to make a payment. The same is true of households.

That is not true of a government that issues its own currency. The UK government is not a household or a business. It is a macroeconomic entity, and it issues the currency that households and businesses use. That difference is fundamental.

When businesspeople say, “You cannot spend what you haven’t got”, they are applying the wrong model. The government does not have to get pounds from taxpayers before it can spend pounds. Instead, money has to be created before anyone can use it to pay tax.

This should also be obvious from double-entry bookkeeping. Every financial asset has a corresponding liability. Every debit has a credit. Government finances cannot, therefore, be understood in isolation from the rest of the economy.

If the government runs a deficit, someone else must have a financial surplus. That is not an opinion. It follows from accounting.

The City has another problem. The existing system suits it well. The idea that governments depend upon financial markets gives the City enormous political power. Governments are told they must maintain “market confidence”, satisfy bond traders and design policy around the wishes of financiers. So, why would the City challenge a story that gives it so much influence?

There is a further problem. Both business and the City talk about money as though it were a thing that exists independently of the economy. It does not.

Money has to be created. Commercial banks create new money when they make loans. The Bank of England creates money when making payments on behalf of the government. Until money has been created, it cannot be spent, taxed, saved or used to buy government bonds.

And money is not a physical thing. It is a record. A bank balance is an entry in a ledger. If someone has a financial asset, someone else must have a corresponding liability. There are always two sides to the entry. Few in business or the City seem to understand that.

That is why relying on businesspeople and the City to explain government finance is so dangerous.

Business applies microeconomic thinking to a macroeconomic problem.

The City has a vested interest in maintaining its power.

And both too often misunderstand the nature of money itself.

That combination is a recipe for economic mismanagement.

We need to start somewhere else. We need to start by understanding how money actually works.