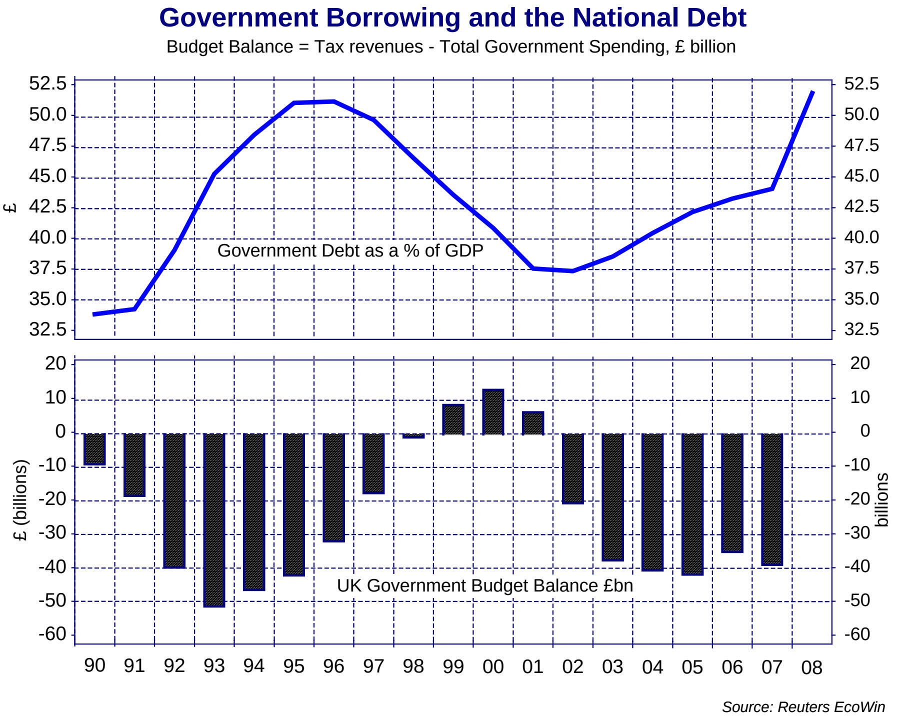
Government Borrowing – the Budget Deficit

When the government is running a **budget deficit**, it means that in a given year, total government expenditure exceeds total tax revenue.



If the government is running a budget deficit, it has to borrow this money through the issue of government debt such as Treasury bills and bonds. The issue of debt is done by the central bank and involves selling debt to the bond and bill markets. Most of the government debt is bought up by financial institutions but individuals can buy bonds, premium bonds and buy national savings certificates.

Does a budget deficit matter?

A persistently large budget deficit can be a problem. Three of the reasons for this are as follows:

1. **Financing a deficit:** A budget deficit has to be financed through the issue of debt and if the budget deficit rises to a high level, the government may have to offer higher interest rates to attract sufficient buyers of debt. This raises the possibility of the government falling into a **debt trap** where it must borrow more simply to repay the interest on accumulated borrowing.

2. **A government debt mountain?** By the summer of 2009 UK government debt was surging above £800bn and is set to rise much higher in the next couple of years. There is an **opportunity cost** involved here because interest payments on bonds might be used in more productive ways, for example on health services or extra investment in education. 100 basis points equates to 1 per cent. Every 5 basis points (0.05%) saved on £220bn of new debt pays one year's salary for 46,000 teachers. Higher public sector debt also represents a transfer of income from people and businesses that pay taxes to those who hold government debt and cause a redistribution of income and wealth in the economy.

3. **Crowding-out - the need for higher interest rates and higher taxes.** If a larger budget deficit leads to higher interest rates and taxation in the medium term and thereby has a negative effect on growth in consumption and investment spending, then a process of '**fiscal crowding-out'** is said to be occurring. There must be a limit to which taxpayers are prepared to pay for government spending. The Institute of Fiscal Studies has estimated that that to reduce the UK budget deficit over the next five years will require every person in the UK to pay over £1250 of extra taxes each year.

4. **Risk of capital flight**: Some economists believe that high borrowing and debt risks causing a 'run on the pound'. This is because the government may find it difficult to find sufficient buyers of its debt and the credit-rating agencies may decide to reduce the rating on UK sovereign debt. If the risks of holding UK government debt go up, some foreign investors may choose to take their money out of the UK driving sterling lower in the currency markets.

2009 – A year when the budget deficit will reach record levels

* In 2009-10 the British government is forecast to spend £4 for every £3 that it receives

* Spending will be more than 48 per cent of GDP

* One in five of Britons now works for the state; more than one in twenty work for the NHS

* Tax revenues will be 36 per cent of GDP

* The gap is the budget deficit - forecast at 12% of GDP

* For taxes to rise by 5% of GDP the government would have to raise the basic rate of income tax by 12% (it is currently at 20%)

Potential benefits of a budget deficit

1. **Government borrowing can benefit growth:** A budget deficit can have positive macroeconomic effects if it is used to finance capital spending that leads to an increase in the **stock of national assets**. For example, spending on transport infrastructure improves the **supply-side capacity and productivity of the economy**.

2. **The budget deficit as a tool of demand management:** Keynesian economists support government borrowing as a way of managing aggregate demand. An increase in borrowing can be a **useful stimulus to demand** when other sectors of the economy are suffering from weak or falling spending. If crowding out is not a major problem - fiscal policy can play an important counter-cyclical role "leaning against the wind" of the economic cycle

Key Concepts

Balanced budget	When total government spending equals tax revenues.
Budget deficit	When government spending is greater than tax revenues.
National debt	The total amount of debt that the government owes the private sector
Tax burden	Total tax revenues as a proportion of a nation's GDP

Suggestions for further reading on government borrowing

Australians to get their tax rebates (BBC news, May 2009)

Guardian guide to government spending and taxation (2009 Budget, March 2009)

Guardian special reports on government borrowing

National debt now the worst since the Second World War (Independent, July 2009)

Rate setter wants £90bn fiscal stimulus (BBC news, February 2009)

The opportunity cost of government debt (Times graphic, April 2009)

UK budget deficit hits record £90bn (Guardian, April 2009)

UK government debt reaches record of £800bn (BBC news, July 2009)