Policy Issue

It has long been assumed that government spending is financed by taxation. This should be challenged, because it is not true. A clear understanding of the mechanisms for funding public expenditure is essential to implementing a sound fiscal policy. The question to be asked is:

*What is the appropriate and effective mechanism for funding public expenditure?*

Background

It is now widely agreed that government spending might be funded in three ways. The first method of funding public expenditure is to increase the supply of government created money in the economy. This increase in the supply of government created money happens every time the government spends. When the government spends it makes a commitment, or promise to pay, and this is accurately reflected in the fact that every banknote in the UK includes a printed version of that promise.

There is, however, a problem with money printing. Unless it is properly controlled it can lead to inflation. All inflation is not bad; on the contrary some inflation is useful. Over recent years we have seen the strenuous efforts made by central banks to avoid deflation. Deflation can have recessionary consequences. The Bank of England sets 2% per annum as its inflation target consistent will sustainable growth. The policy challenge is to permit the injection of just enough money to achieve this goal, taking other factors into account.

Broadly speaking, the way to do this is by taxing most of the money a government creates through its spending out of existence soon after that spending takes place. Tax fulfils two goals in this process. First, it controls inflation, and this role is now seen by many as the primary purpose of taxation. Second, in effect the government endorses the value of its own currency by requiring that tax be paid making use of that money it creates. However, to ensure that happens spending that delivers public services must takes place before tax can be charged. Unless this were the case the money to make tax payment by households and businesses would not exist. By accepting its own currency in settlement of tax obligations the government fulfils its “promise to pay”. This circuit, in which a government creates money to fund expenditure that is returned as tax payments is the concrete way in which the government creates, delivers and maintains a stable currency for use in trade.

A growing economy requires general price increases, or inflation. Except under unusual circumstances, a general increase in prices requires an increasing money supply. A fiscal deficit is the only way in which money can be injected into an economy continuously. It
follows that governments must run a near perpetual deficit or face the risk of creating a 
liquidity crisis due to a shortage in the money supply, which would then create a risk of 
deflation.

The question then arises as to how this deficit should be funded in a fiat monetary 
system; that is, a monetary system in which money itself lacks value (in contrast to a 
system in which gold was convertible into money). ‘Fiat’ in this context means that the 
money in an economy is only backed by the government's promise to pay and has no 
other convertible value except for the payment of tax.

There are, in essence, three ways in which a government can fund a deficit. The first and 
most obvious of these would be for the government run an overdraft with its central bank, 
which is the Bank of England in the case of the UK. There would be no reason for 
interest to be paid on this overdraft if the government owns the central bank, as is the 
case in the UK, because paying interest to oneself is merely an accounting exercise.

Historically a central bank offering a government an apparently unlimited overdraft was 
considered profoundly imprudent. That was because until 1971, when the USA came off 
the gold standard, all currencies were ultimately restricted in their availability by the 
conversion requirement into gold under what came to be called the Bretton Woods 
System. The ability of the government to print money without constraint, which a central 
bank overdraft for its government implied, threatened monetary stability as a 
consequence. As a result the government's deficit was in effect repackaged in the form of 
bonds (or gilts). These interest bearing bonds were sold by the government to third-
parties. In this way the gilts market was created.

What that market effectively ensured until 1971 was that the government must use money 
already in existence for its spending. When the amount of money was fixed to existence 
of gold this was an appropriate goal. Since the link with gold has been removed the 
constraint imposed by having to borrow makes no sense: there is no limit, subject to 
inflation objectives, to the amount of money that might usefully exist.

That said, although the gilts market is, in theory, now entirely unnecessary for the 
purposes of funding government deficits it has turned out that in practice there are 
significant, and overall beneficial, uses for government created bonds. The most obvious 
is as a place of guaranteed safe deposit for those with funds they wish to save. A 
government can never default on a bond that it issues in its own currency because it can 
always instruct its central bank to create the money required to make repayment of a 
bond when redemption is due. As a consequence the owners of gilts have an absolute 
guarantee that their funds are safe. This is fundamental to the financial security of an 
economy.

That said, this means that government bonds are an asset with very low inherent risk. As 
a consequence, gilts have the lowest interest rate paid in any market. Despite this they 
still have great appeal to pension fund trustees and insurance companies, both of which 
have an obligation to settle liabilities far into the future.
Gilts also appeal to those who wish to deposit extremely large amounts for short periods of time. Very large amounts cannot receive the guarantee that the government gives normal bank depositors. In particular, companies seeking to place millions and even billions of pounds on deposit overnight seek security for their cash. They achieve this security not by placing the funds in bank accounts, but by temporarily purchasing government bonds from banks. These they then sell back to government the following morning at a very marginally higher price to cover the interest earned. This is called the ‘repo’ market.

As a practical matter it would be very difficult if not impossible to replace gilts in the pension, insurance and banking sectors with a private sector security instrument. As a consequence there is a systemic need to issue gilts. However, the idea that the government is dependent upon doing so to raise funds is a legacy of the pre-1971 monetary era. It is no longer true. Gilts are now issued as a favour to the financial markets to provide a safe deposit service to the market that it needs. They are not issued to fund government expenditure, because they are not needed for this purpose. This is precisely why real interest rates on gilts have shown a markedly downward trend over time, and they now carry an effective near zero interest rate.

Unfortunately international regulation has not recognised this fact. As a result the EU still bans banking central bank lending to the governments that own them, reflecting thinking from the pre-1971 system. This ban is, however, now worked round using the technique known as quantitative easing (QE). QE occurs when a central bank (or one of its subsidiary companies) purchases gilts issued by the government that owns it.

The Bank pays for these gilts by crediting the account of the seller of those gilts (for example, a pension fund) with an amount equal to the value of the bonds purchased. The money for this transaction is not provided by taxpayers. It is instead created out of thin air by the Bank of England lending it to one of its own subsidiaries to buy the gilts in question, in exactly the same way as all bank loans are created by the sue of double entry book-keeping.

The result is that the ownership of a government owed debt is transferred to a government-owned bank. In effect the government has then lent itself money. This self-lending is strictly equivalent to printing currency, and more practical for the large sums involved in the QE process. Whether the loans involved then have interest paid on them is of no importance, since the interest payments cancel itself out (appearing in the national accounts as an expenditure from the government to the central bank, and an income from the central bank to the government). QE does then permit a central bank to provide its government with a long-term interest free loan that also has no set repayment date. This no interest, infinite maturity date loan provides a funding mechanism for government expenditure that is an alternative to taxation. In formal terms this is expressed as:
G is government spending
T is tax revenue
t is the time period (for example 2018)
\(\Delta B = B(t) - B(t-1)\) is the change in the level of government borrowing
\(\Delta M = M(t) - M(t-1)\) is the change in the level of government created money in a period (most of which, will be QE)

These produce the following identity, which is turn by definition.

\[ G = T + \Delta B + \Delta M \]

In words, government spending must equal taxation plus the change in government borrowing plus the change in government created money.

The policy implications are clear. The perennial question of ‘how is it going to be paid for’ is answered by this equation. All government spending is initially paid for by creating new money. The new money provides the means to either collect additional tax revenue, or to fund new gilt issues. If there was a risk of deflation and neither tax increases or bond issued were desirable, then this identity makes clear that a government can alternatively create and repurchase its own debt to fund its spending. At an aggregate level the government can adjust the elements of the identity to foster full employment, subject to inflationary pressure. As such it is this equation that is at the core of managing the macroeconomy.

**Policy Framework**

The spending-funding identity explained in this briefing makes clear that governments, and not markets, are the drivers of the decision-making on the level of taxation, borrowing, interest rates and the optimal balance between these factors. That optimal balance is the value of each that is consistent with the government's policy goals. If, for example, the government seeks to achieve full employment, then what this approach suggests is that it is at complete liberty to do so without market interference. So long as there is spare capacity within the economy that needs to be usefully employed the government can create new funding to achieve that goal. Should the increase in demand generate undesired inflation, the government can either cancel the additional spending by greater taxation or by selling its bonds in the financial market (which transfers private liquidity to the government).

A government with its own currency can, if it chooses, take command of their own financing and as a consequence of the national economy and it is not beholden to the financial markets.

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