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Economics Revision Focus: 2004

AS & A2 Economics

# Economics of the Budget Deficit

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## Revision Focus on the Economics of the Budget Deficit

### AS Syllabus Requirements

Candidates should understand how fiscal policy can be used to influence aggregate demand and aggregate supply

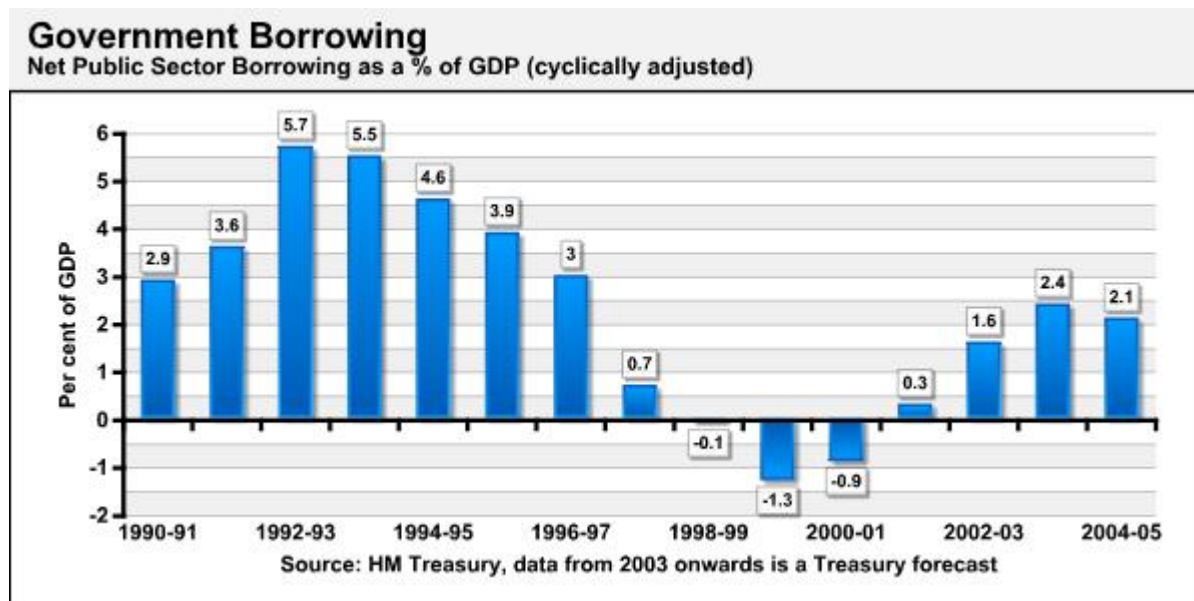
### A2 Syllabus Requirements

Candidates should be able to discuss the importance of the budget balance and assess the significance of changes in the level and distribution of public expenditure.

### Government borrowing

The level of government borrowing is an important part of **fiscal policy** and management of aggregate demand in any economy. When the government is running a **budget deficit**, it means that in a given year, total government expenditure exceeds total tax revenue. As a result, the government has to borrow through the issue of debt such as Treasury Bills and long-term government Bonds. The issue of debt is done by the central bank and involves selling debt to the bond and bill markets.

### Recent trends in UK government borrowing

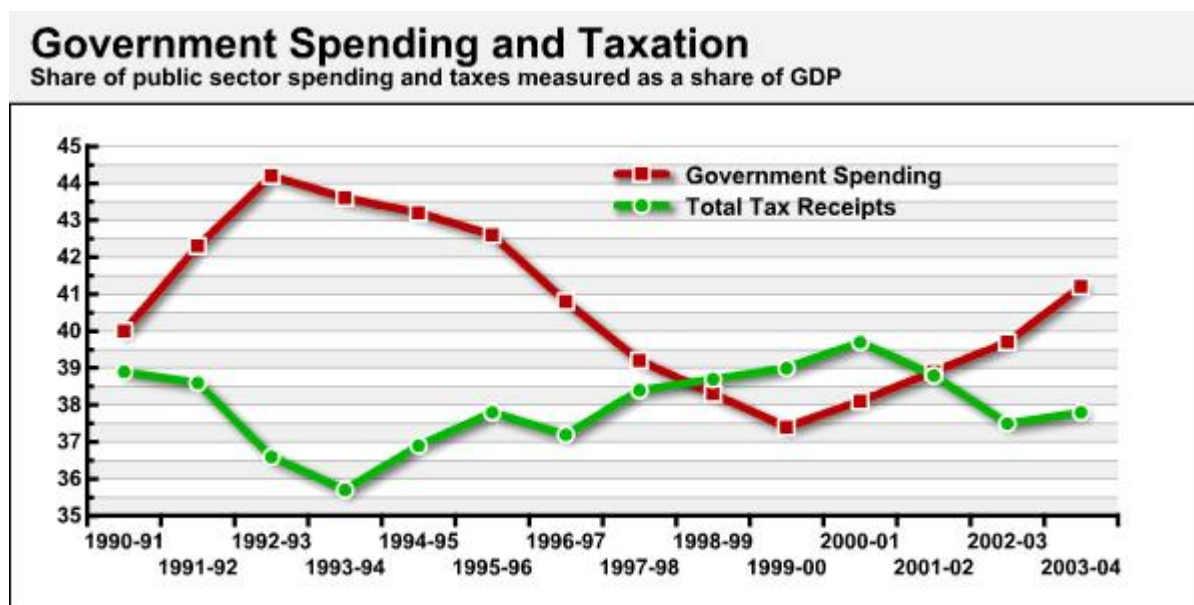


The chart above shows government borrowing for the UK expressed as a percentage of GDP. The data is also **adjusted for the cycle** because the amount that the state has to borrow is sensitive to what is happening in the economy as a whole. For example, a slowdown or recession has the effect of reducing tax revenues from direct and indirect taxes whilst at the same time boosting government spending on welfare and causing a higher level of borrowing.

Government finances have moved from surplus in the late 1990s to a deficit of over 2% of GDP in 2003-04. The emergence of a rising budget deficit has been due to a weaker economy and the effects of substantial increases in government spending on priority areas such as health, education, transport and

defence. Both current and capital spending are rising sharply in real terms. Critics of Gordon Brown argue that he risks losing control of the budget deficit if tax revenues continue to come in below forecast whilst public sector spending remains high. Gordon Brown's reputation of fiscal prudence has come under pressure during 2003 and 2004.

The next chart plots total tax revenues and total government spending as a share of GDP since 1990 – again the budget balance is the difference between the two line charts. This data is not adjusted for the cycle. It shows that the forecast budget deficit for 2003-04 is above 3% of national income.



### Does a budget deficit matter?

There is a consensus that a persistently large budget deficit can be a major problem for the government and the economy. Three of the reasons for this are as follows:

1. **Financing a deficit:** A budget deficit has to be financed and day-to-day, the issue of new government debt to domestic or overseas investors can do this. In a world where financial capital flows freely between countries, it can be relatively easy to finance a deficit. But it may be that if the budget deficit rises to a high level, in the medium term the government may have to offer higher interest rates to attract sufficient buyers of government debt. This in turn will have a negative effect on economic growth
2. **A government debt mountain?** In the long run, a high level of government borrowing adds to the accumulated **National Debt**. This means that the Government has to spend more each year in debt-interest payments to holders of government bonds and other securities. There is an **opportunity cost** involved here because interest payments might be used in more productive ways, for example an increase in spending on health services. It 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.** Eventually the budget deficit has to be reduced. This can be achieved by either by cutting back on public sector spending or by raising the burden of taxation. 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 household consumption and investment spending, then a process of **'fiscal crowding-out'** is said to be occurring.

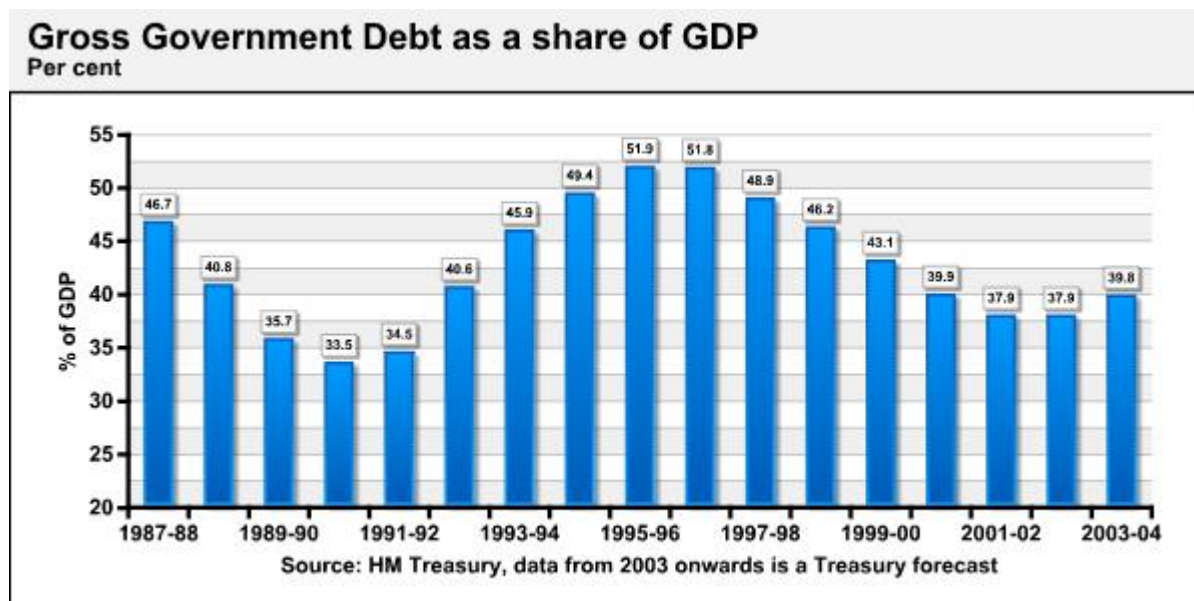
4. **Wasteful public spending:** Neo-liberal economists are naturally opposed to a high level of government spending. They believe that a rising share of GDP taken by the state sector has a negative effect on the growth of the private sector of the economy. They are sceptical about the benefits of higher spending believing that the scale of waste in the public sector is high – money that would be better off being used by the private sector.

### Potential benefits of a budget deficit

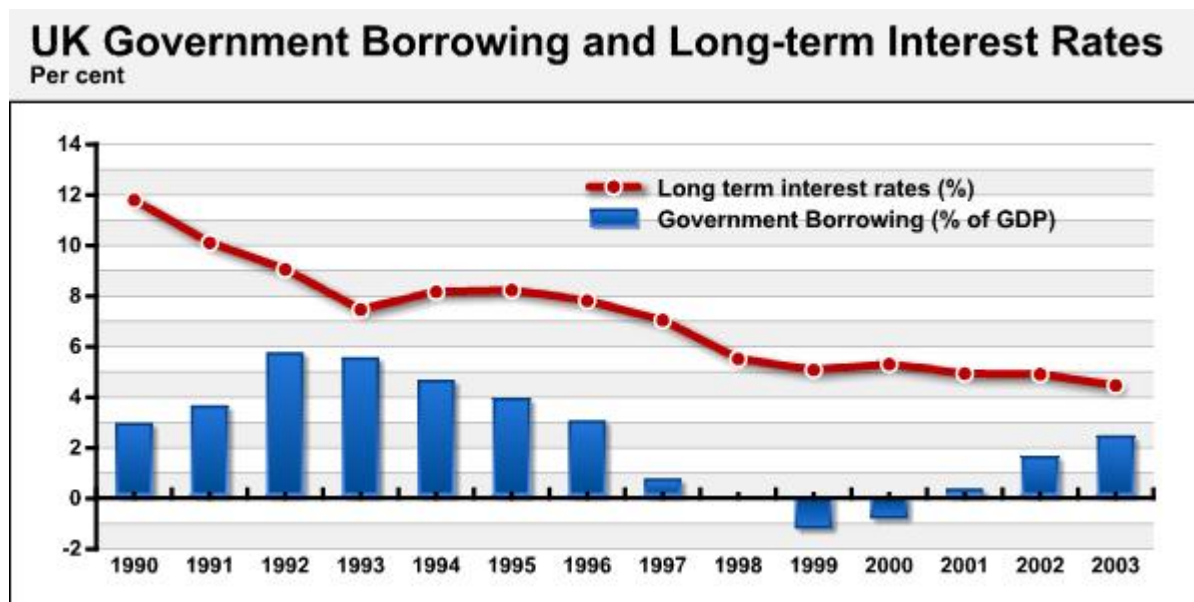
What are the main economic and social justifications for a higher level of government spending and borrowing? Two main arguments stand out

1. **Government borrowing can benefit economic growth:** A budget deficit can have positive macroeconomic effects in the long run if it is used to finance extra capital spending that leads to an increase in the **stock of national assets**. For example, higher spending on the transport infrastructure improves the **supply-side capacity of the economy** promoting long-run growth. And increased public-sector investment in health and education can bring positive effects on **labour productivity and employment**. The **social benefits** of increased capital spending can be estimated through use of **cost-benefit analysis**.
2. **The budget deficit as a tool of demand management:** Keynesian economists would support the use of changing the level of government borrowing as a perfectly legitimate instrument 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. The fiscal stimulus given to the British economy during 2002-2004 has been important in **stabilizing demand and output** at a time of global economic uncertainty. Perhaps Keynesian fiscal demand management has once more come back into fashion! The argument is that the government can and should use fiscal policy to keep real national output closer to potential GDP so that we **avoid a large negative output gap**. Maintaining a high level of demand helps to sustain growth and keep unemployment low. If economic growth is maintained, tax revenues will remain high and help to finance the extra government spending

### The current situation



1. Government borrowing in the UK has shot up to 3.4 percent of GDP in the last fiscal year, in excess of the 3.0 percent limit set by Europe's Stability and Growth Pact
2. But as the UK is not participating in the single European currency, the UK is not bound by the terms of the fiscal stability pact and this gives it more flexibility in terms of how much the UK government can borrow
3. The government has allowed the **automatic stabilisers** to work during the current economic cycle. In other words, it has allowed an increase in government borrowing brought about by a slowdown in domestic demand and output. This has helped to maintain economic growth in the short run
4. Gordon Brown has his own **fiscal rules** – including the golden rule that government spending on currently provided goods and services should be financed by taxation over the course of the economic cycle. Government capital spending (public sector investment) can be financed by borrowing
5. Although government borrowing is currently high, there is little upward pressure on long-term interest rates (indeed they are very low). Financing the budget deficit is not a major problem for the UK as it seems able to attract inflows of financial capital from overseas – and foreign investors are happy to purchase new issues of government debt
6. One reason is that total government debt as a percentage of GDP remains low by historical standards (less than 40% of GDP). And with interest rates remaining low, the government is not facing up to a huge cost of servicing this debt
7. It is difficult to forecast government borrowing with great accuracy. Firstly this is because government tax revenues and spending is sensitive to changes in the economic cycle. Secondly, we are dealing with huge numbers! Total government spending in 2003-04 is forecast to be £459 billion and total tax receipts £422 billion (giving a forecast budget deficit of £37 billion). It only takes government spending and tax revenues to be 1% or 2% different from current forecasts for the budget deficit to change significantly



## Where the money goes to

Total managed government spending for 2004-05 £billion, source: Treasury Red Book April 2004

