Chapter 36

Public sector borrowing and public sector debt

Key terms

1. Fiscal deficit : is when government spending is greater than its income in a given year.
2. Fiscal surplus : is when government spending is lower than its revenue in a given year.
3. Automatic stabilizers: mechanisms which affect levels of government spending and taxation, without any direct intervention by the government, when national income changes; they occur automatically and act to minimize fluctuations in actual GDP around the long-term growth rate.
4. Debt servicing: the regular repayment which need to be made to the lender on outstanding loans; this includes interest repayments.
5. Discretionary fiscal policy: the deliberate manipulate of government spending and taxes to influence the economy
6. Fiscal austerity: tax rises or government spending cuts designed to reduce a fiscal deficit.
7. Intergenerational equity: fairness between different generations
8. National debt: the total accumulated borrowing of the government which remains to be paid to lender.
9. Primary deficit or surplus: the actual fiscal deficit or surplus, not taking into account interest payments on the national debt.
10. Current budget deficit: occurs when government revenues are less than current expenditure; it does not include government capital expenditure.
11. Structural deficit: the part of a fiscal deficit that exist even when the cyclical deficit is zero at the top of a boom
12. Cyclical deficit: that part of the fiscal deficit which is caused by government spending and taxed changing through the trade cycle.

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1. Fiscal deficit and fiscal surplus

- **Fiscal deficit** : is when government spending is greater than its income in a given year. A fiscal deficit means a government must borrow that year to finance its spending.
- **Fiscal surplus** : is when government spending is lower than its revenue in a given year.

2. Automatic stabilisers and discretionary fiscal policy

- **Automatic stabilizers:** mechanisms which affect levels of government spending and taxation, without any direct intervention by the government, when national income changes; they occur automatically and act to minimize fluctuations in actual GDP around the long-term growth rate.
  - During recession, people lost jobs and income. Government spending on unemployed benefits rises and government tax revenue fall without changes the policy rate.

- **Discretionary fiscal policy:** the deliberate manipulate of government spending and taxes to influence the economy.
  - Government deliberate increases spending on submarine.

3. Cyclical and structural deficits

- **Cyclical deficits:** that part of the fiscal deficit which is caused by government spending and taxed changing through the trade cycle.

- **Structural deficits:** the part of a fiscal deficit that exist even when the cyclical deficit is zero at the top of a boom

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4. Current budget deficits, primary budget deficits and actual budget deficits

- **Current budget deficits**

Current budget deficit: occurs when government revenues are less than current expenditure; it does not include government capital expenditure.

- **Primary budget deficits**

Primary deficit or surplus: the actual fiscal deficit or surplus, not taking into account interest payments on the national debt.

Primary deficit = actual deficit - debt interest payments

- **Actual budget deficits**

Actual deficit = Primary deficit + debt interest payments

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5. Factors influencing the size of fiscal deficits and surpluses and the national debt in nominal terms

Several factors influence the size of fiscal deficits and surpluses measured in money terms

5.1 State of the economy

- Economic recession causes cyclical deficit from automatic stabilizer on level of government spending and tax revenue.

5.2 Demographic factors

- Aging population can cause government budget deficit.

5.3 Responsible government financing

- Governments have deliberately cut spending and raised taxation to reduce fiscal deficits to target level.

5.4 Taxation

- Government might prioritize the reduction of tax avoidance and tax evasion. This can reduce fiscal deficit.

5.5 Economic development

- Government may borrow money rot finance a project to develop a country.

5.6 Price of commodities

- Some countries, tax revenue depends on commodity price. The country exporting oil will gain higher tax revenue when price of oil rises.

5.7 Debt interest

- The rate of interest paid on new borrowing will depend on 2 factors; including market interest rate and credit rating of the government.

5.8 Unforeseen events

- Government has higher spending to help people during covid pandemic.

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6. The significance of the size of fiscal deficits and national debts

6.1 The impact on interest rates

- All other things being equal, a rise in government borrowing in national economy should lead to a rise in market interest rate in that country.
- This is because the demand for borrowed funds rises relative to existing supply. The price of borrowed money is the rate of interest.
- So the rise in demand for borrowed funds leads to a rise in interest rates.
- This may crowd out private sector spending.

6.2 Debt servicing

- Debt servicing: the regular repayment which need to be made to the lender on outstanding loans; this includes interest repayments.

6.3 Intergenerational equity

- **Intergenerational equity** : refers to fairness between different generations. Some economists and politicians have argued strongly that increasing fiscal deficits and national debts benefit current citizens at the expense of future generation.

6.4 Foreign direct investment (FDI)

- FDI can increase foreign currency to make repayment on the country's debt.
- However, countries with severe fiscal deficits are more likely to have a fall in FDI.

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Exercise

1. With reference to a country of your choice, discuss the factors that might cause its economy to have a fiscal deficit. (15 marks)

2.

(A) Discuss the likely impact of the rapid growth of emerging and developing economies on world trade patterns. 'China has specialised in manufacturing while India has specialised in services'. (15 marks)

(B) Evaluate the possible benefits of such specialisation to a country or countries of your choice. (20 marks)

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