
Public sector finances

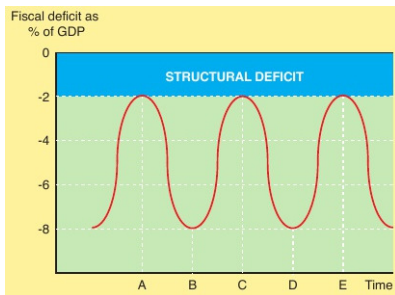
Chapter 81 – May, 2017

FISCAL SURPLUSES AND DEFICITS AND THE NATIONAL DEBT

- ▶ *Fiscal deficits/surpluses* → direct impact on *National Debt*
- ▶ National Debt: total of all unpaid government borrowing from previous years
- ▶ Example:
 - ▶ If *fiscal deficit* of £20 billion then *National Debt* increases by £20 billion
 - ▶ If *fiscal surplus* of £30 billion then *National Debt* decreases by £30 billion
- ▶ 2 ways of measuring *fiscal balances* and *National Debt*:
 1. in money terms
 2. as a percentage of GDP
- ▶ *percentage of GDP* measure is preferred → assess ability of government to repay the debt

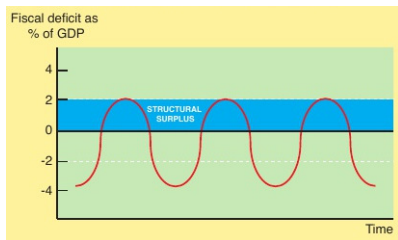
CYCLICAL AND STRUCTURAL DEFICITS

- ▶ *cyclical deficit*: government spending and revenues fluctuate through the *trade cycle*
 - ▶ when *economy is in boom*: benefits (welfare, unemployment) are low and tax revenues are relatively high
 - ▶ when *economy is in recession*: government spending high and tax revenues low



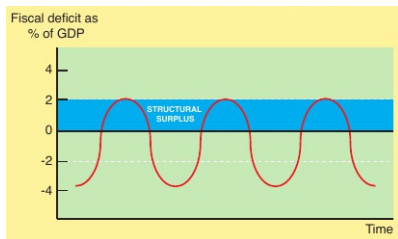
CYCLICAL AND STRUCTURAL DEFICITS

- ▶ *structural deficit*: the fiscal deficit which occurs when the cyclical deficit is lowest
- ▶ actual deficit = cyclical deficit + structural deficit
- ▶ *structural balance*: occurs when at the peak of a boom, the actual fiscal balance is zero
- ▶ *structural surplus*: occurs when at the peak of a boom, there is an actual fiscal surplus



CYCLICAL AND STRUCTURAL DEFICITS

- ▶ If government has *structural deficit*, it is likely that *National Debt* will grow over time!
 - ▶ reason: government will have to continue borrowing money
 - ▶ therefore structural deficits have to be eliminated (i.e., raise taxes, cut government spending)
- ▶ see last paragraph p. 526

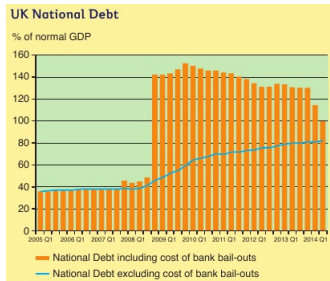


CURRENT BUDGET DEFICITS, PRIMARY BUDGET DEFICITS AND ACTUAL BUDGET DEFICITS

- ▶ *current expenditure*:
 - ▶ government consumption (i.e., day-to-day spending on education, defence, health services),
 - ▶ welfare payments, and
 - ▶ debt interest
- ▶ *capital expenditure*: government spending on investment goods (i.e., new roads, new schools, new hospitals)
- ▶ *current budget deficit*: when government revenues < current expenditures
 - ▶ over the trade cycle, government needs to run a current budget surplus, or
 - ▶ governments have to borrow to finance *investment expenditures*
- ▶ *primary budget deficit/surplus* \neq *actual budget deficit/surplus*
primary deficit + debt interest payments = actual deficit

FACTORS INFLUENCING THE SIZE OF FISCAL DEFICITS AND SURPLUSES AND THE NATIONAL DEBT IN NOMINAL TERMS

- ▶ structural deficits and surpluses:
- ▶ cyclical deficits and surpluses:
- ▶ unforeseen events:
- ▶ debt interests:



FACTORS INFLUENCING THE SIZE OF FISCAL DEFICITS AND SURPLUSES AND THE NATIONAL DEBT IN NOMINAL TERMS

STRUCTURAL DEFICITS AND SURPLUSES

- ▶ spending and tax decisions of governments affect *structural deficits/surpluses*
- ▶ governments are under pressure to
 - ▶ ↑ government spending
 - ▶ ↓ taxes
- ▶ economic state affects *structural deficits/surpluses*:
 - ▶ if economy is doing well → expectation that it will do well in the future
 - ▶ temptation to increase government spending and decrease taxes to satisfy voters

FACTORS INFLUENCING THE SIZE OF FISCAL DEFICITS AND SURPLUSES AND THE NATIONAL DEBT IN NOMINAL TERMS

CYCLICAL DEFICITS AND SURPLUSES

- ▶ cycle in GDP affects cyclical deficits/surpluses
- ▶ in the short term governments don't control this
- ▶ Example:
downturn \rightarrow house prices \downarrow \rightarrow property transactions \downarrow \rightarrow
property tax revenue \downarrow

FACTORS INFLUENCING THE SIZE OF FISCAL DEFICITS AND SURPLUSES AND THE NATIONAL DEBT IN NOMINAL TERMS

UNFORSEEN EVENTS

- ▶ governments may have to cover for unforeseen events:
 - ▶ floods
 - ▶ natural disasters
 - ▶ financial crisis of 2008-09
- ▶ *bail out* of banks → fiscal deficit will increase

FACTORS INFLUENCING THE SIZE OF FISCAL DEFICITS AND SURPLUSES AND THE NATIONAL DEBT IN NOMINAL TERMS

DEBT INTEREST

- ▶ Debt interest is determined by two factors:
 1. size of the National Debt
 2. rate of interest, which depends on
 - ▶ *market rate* of interest
 - ▶ *credit rating* of the government (i.e., risk)
- ▶ Note: A government can increase its borrowing and yet the total amount of interest paid on its National Debt falls!
 - ▶ this is possible if government is able

FACTORS AFFECTING FISCAL DEFICITS AND SURPLUSES AND THE NATIONAL DEBT AS A PERCENTAGE OF GDP

- ▶ Relation between *fiscal balance*, *National Debt*, and *GDP*:

- ▶ ↑ GDP

- *cyclical* budget balance improves

- $\frac{\text{budget balance}}{\text{GDP}} \downarrow$

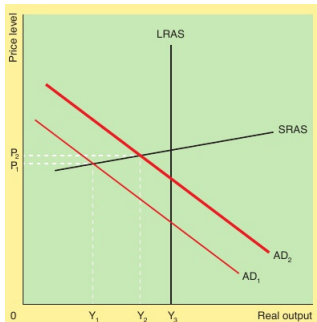
- ▶ ↓ GDP

- *cyclical* budget balance deteriorates

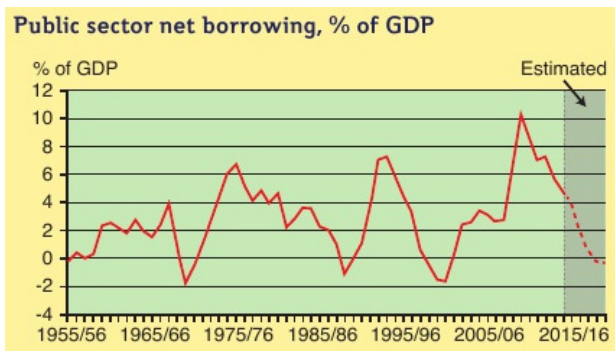
- $\frac{\text{budget balance}}{\text{GDP}} \uparrow$

IMPLICATIONS FOR OTHER VARIABLES OF FISCAL DEFICITS AND NATIONAL DEBTS

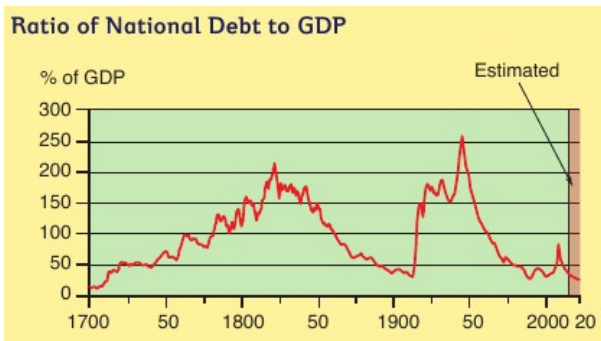
- ▶ interest rates:
- ▶ debt servicing:
- ▶ inter-generational equity:
- ▶ the rate of inflation:
- ▶ credit ratings:
- ▶ Foreign Direct Investment (FDI):



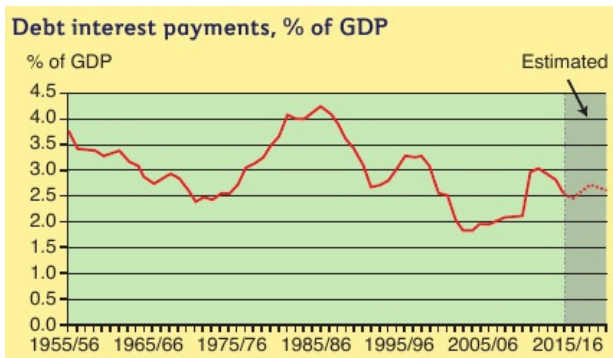
EXTRACT 1: THE UK FISCAL BALANCE AND THE NATIONAL DEBT



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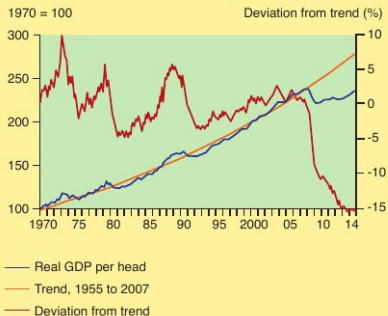
EXTRACT 1: THE UK FISCAL BALANCE AND THE NATIONAL DEBT



EXTRACT 2: THE BRITISH ECONOMY AFTER THE COALITION



UK real GDP per head: index of actual GDP per head, index of long-term trend (1955-2007) and % deviation from the trend



KEYTERMS

- ▶ current budget deficit:
- ▶ cyclical deficit:
- ▶ primary deficit or surplus:
- ▶ structural deficit: