

## IS PUBLIC SECTOR BORROWING TOO HIGH?

In recent years the high level of government borrowing has been at the centre of economic and political debate. On the one hand the public sector borrowing requirement (PSBR) is blamed for record mortgage rates and the threat that industry may be starved of the funds it needs. On the other, proposals which are likely to cut the PSBR are denounced as deflationary and damaging to living standards. Some claim that a high PSBR is a cause of inflation, whilst others argue that if proper account is taken of inflation the PSBR is much less formidable than it seems. This article attempts to set out some facts about the sources and extent of public sector borrowing and to consider briefly some of the issues involved.

### Trends in the PSBR

There is no doubt that the apparent growth of the PSBR has been magnified by inflation. When prices double in less than 5 years comparisons in money terms can be grossly misleading. Thus, for example, although at over £8,000 million in 1978 the PSBR was twice its 1973 value in money terms, after allowance is made for inflation the real value was actually slightly less. Moreover, public sector activities have to be viewed in relation to the economy as a whole. A useful measure, which eliminates distortions due to inflation, is therefore the ratio of the PSBR to GDP, and this is shown in Figure 1 for the period since 1966.

During the 1960's the PSBR averaged some 2½% of GDP. It rose to over 4½% in 1967, but the measures to restrain demand which followed devaluation at the end of 1967 cut it back sharply; by 1969 the public sector was actually repaying debt, amounting to as much as 1% of GDP, and in 1970 it remained virtually in balance. In the next 5 years borrowing rose very sharply to a peak of 10% of GDP in 1975, since when it has been reduced to around 5% of GDP, still well above the average of the sixties. (The rise in 1979 has been associated with temporary factors, such as delayed payments of telephone bills and the timing of VAT payments.)

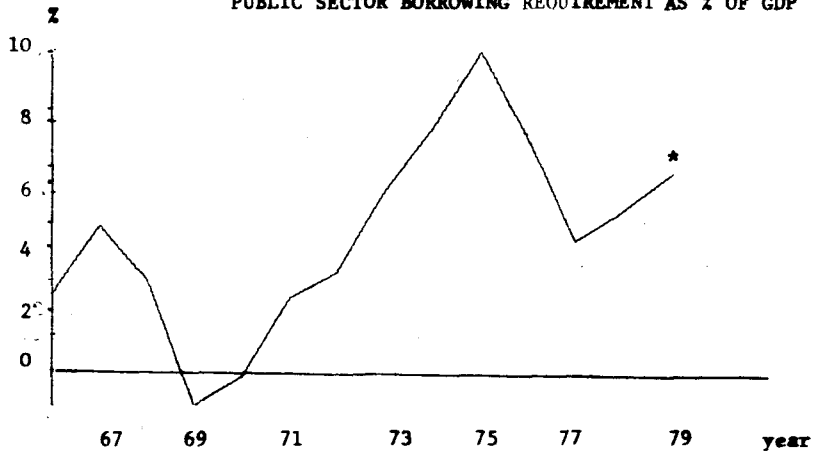
In considering its borrowing the public sector is often treated as a whole because much of the necessary finance is raised by the government centrally and because policy decisions are often taken by reference to the activities of the whole public sector. But the PSBR has its origins in the separate activities of the central government, local authorities and public corporations, each of which have their own sources of revenue and their own spending programmes. In broad terms borrowing by a sector is necessary if its current revenue falls short of its current spending or, more commonly, because the excess of current revenue over current expenditure (a sector's saving) is insufficient to finance the sector's capital investment programme. The excess of capital spending over saving is known as the sector's financial deficit. Apart from borrowing to finance its own financial deficit, a sector also has to borrow if it adds to its financial asset holdings, for example by purchasing securities or making loans to other sectors. Figures 2 - 4, show the saving, investment and financial deficits of the public corporations, local authorities and central government respectively.<sup>1</sup>

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<sup>1</sup> Saving has been measured as the excess of current revenue over current costs, calculated after deducting stock appreciation and depreciation on a replacement cost basis. Capital grants made or received by the sector have also been included in saving. Investment includes structures, equipment, and the physical increase in stocks, but is net of depreciation ie it excludes the investment needed to maintain the existing capital stock.

FIGURE 1

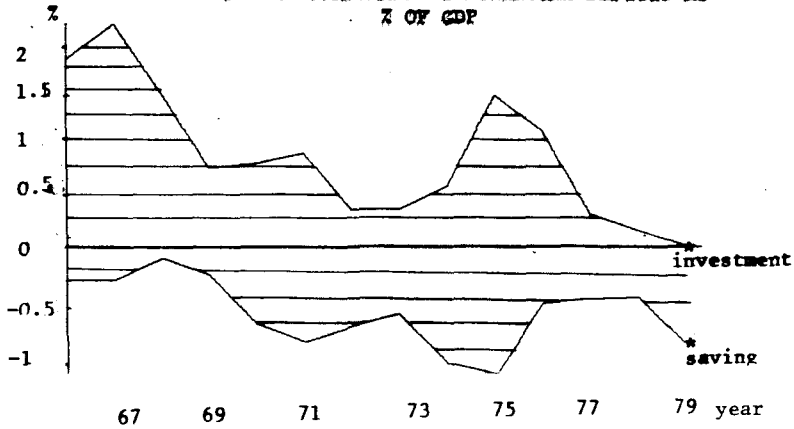
PUBLIC SECTOR BORROWING REQUIREMENT AS % OF GDP



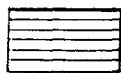
\* Estimate

FIGURE 2

PUBLIC CORPORATIONS FINANCIAL DEFICIT AS % OF GDP



\* Estimate



Financial Deficit

FIGURE 3

LOCAL AUTHORITIES DEFICIT AS % OF GDP

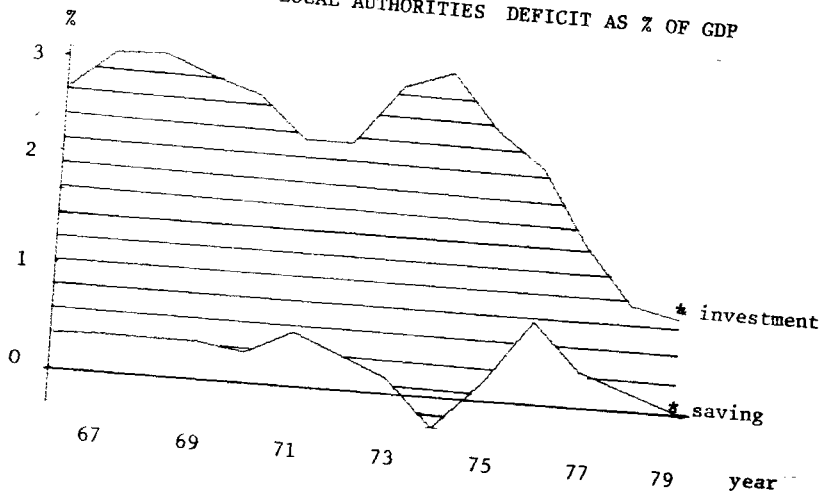
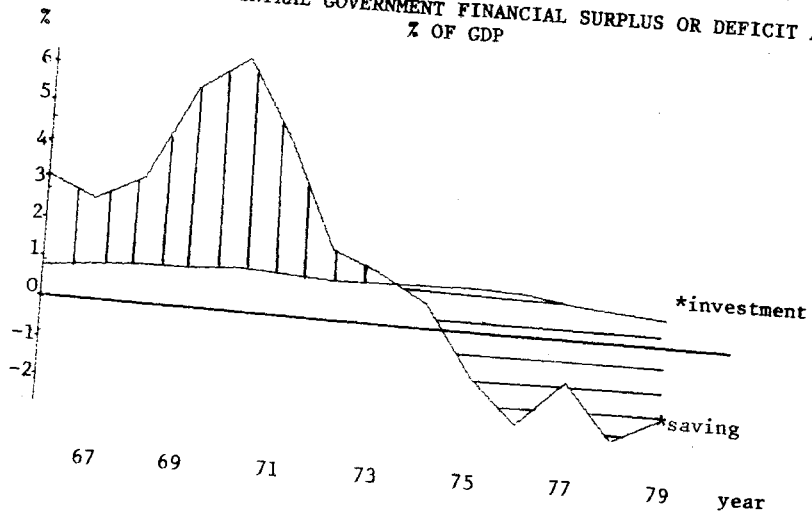


FIGURE 4

CENTRAL GOVERNMENT FINANCIAL SURPLUS OR DEFICIT AS % OF GDP



\* Estimate



 Financial Deficit  
 Financial Surplus

Figure 2 shows that the public corporations as a whole have run at a loss<sup>1</sup> in every year since 1966 - the profits earned by the more successful corporations such as British Gas have not been enough to offset the deficits of the less profitable such as British Steel. There was a tendency for this loss (dis-saving) to increase in the first half of the 1970's, but since then it has been between  $\frac{1}{2}$ % and 1% of GDP. At over 2% of GDP, net investment by public corporations reached a peak in 1967, but after that curbs on capital programmes caused a fall to only about  $\frac{1}{2}$ % of GDP by 1972 and 1973. Expansion in the next two years was followed by further curbs, so that the net investment has now practically ceased. The peak financial deficit - almost 3% of GDP - occurred in 1975; since then it has been cut to about 1%, very largely as a result of the fall in investment.

Local authorities have generally managed to have a surplus on their current operations (Figure 3). Their saving has been positive in every year except 1974, when the rapid rise in wage and salary costs caught them unprepared; by contrast, over-provision in the level of rates for possible wage and salary increases in 1976 led to a greater than usual surplus. By and large the fluctuations in saving by local authorities have been slight and for the most part unintentional. Net investment at the end of the 1960's amounted to about 3% of the GDP, and while it was affected by the restraints on public spending at the end of the decade it rose again to a peak of over 3% in 1974. Since then there has been a steady decline to about 1% of GDP.<sup>2</sup> At the end of the 1960's the local authorities were running a financial deficit of about  $2\frac{1}{2}$ % of GDP. After falling to under 2% in 1971 this rose to nearly  $3\frac{1}{2}$ % in 1974, when the investment peak coincided with the current account deficit, before falling back to under 1% now.

Figure 4 demonstrates clearly that the major cause of the increase in the PSBR has been the decline in saving by the central government. Throughout the 1960's the central government had a financial surplus - its tax revenue exceeded its current spending, including grants to other sectors. The government therefore made a significant contribution to saving each year, rising to a peak of over 6% of GDP in 1970. Thereafter tax cuts and rising government expenditure caused a precipitous fall; by 1976 the surplus had vanished and the central government was dis-saving to the extent of over  $2\frac{1}{2}$ % of GDP. While the balance between revenue and current spending improved in 1977, dis-saving has since increased again to about  $2\frac{1}{2}$ % of GDP. Central government investment has varied comparatively little as a proportion of GDP, though it has been falling recently.

The three components of the public sector are brought together in Figure 5, which shows saving, investment and the financial surplus or deficit of the public sector as a whole. Saving rose to a peak of 6% of GDP in 1970, but has since been reduced by about 10% of GDP until now dis-saving amounts to some 4%. Investment has fallen from about 5% of GDP at the end of the 1960's, to about  $1\frac{1}{2}$ % of GDP. The overall financial deficit, which averaged under  $2\frac{1}{2}$ % of GDP in the 1960's and moved into surplus in 1969 and 1970, reached a peak of  $7\frac{1}{2}$ % of GDP in 1975 and still amounts to about 5% of GDP.

When public sector organisations make loans or purchase securities they have to raise the necessary finance themselves, and this adds to the PSBR. Examples are loans by local authorities for house purchase, government loans as part of the overseas aid programme, loans for export credit, loans to industry and the purchase of equity shares to assist companies in difficulties or to help them to expand. The public sector is also affected by the timing of tax and other payments.

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<sup>1</sup> After removing inflationary gains in stock and allowing for depreciation on a replacement cost basis.

<sup>2</sup> The decline has been exaggerated slightly by the fact that local authorities now lease some capital equipment which they would previously have bought.

FIGURE 5 PUBLIC SECTOR FINANCIAL SURPLUS OR DEFICIT AS % OF GDP

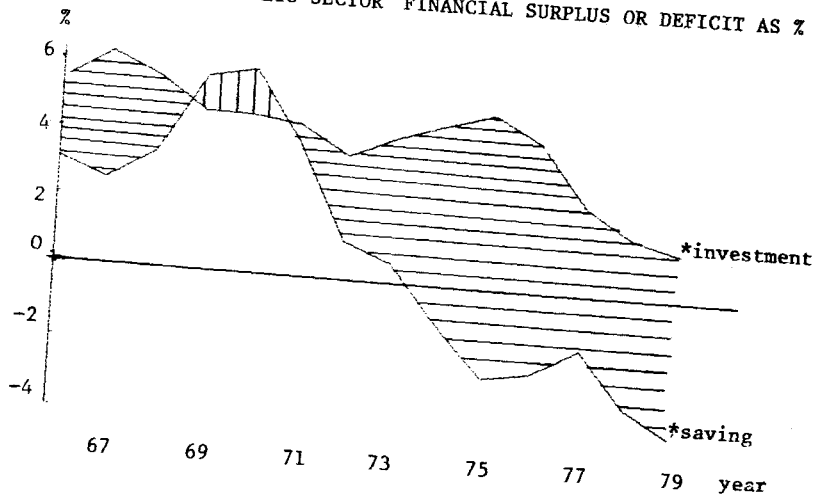
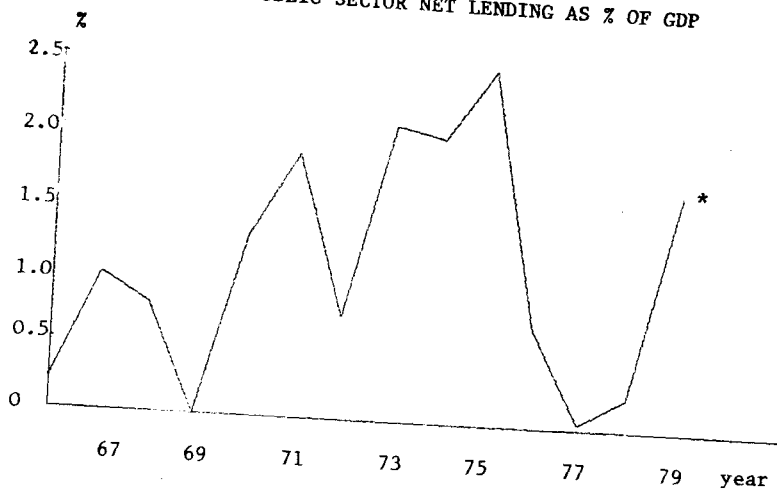


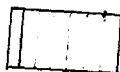
FIGURE 6 PUBLIC SECTOR NET LENDING AS % OF GDP



\* Estimate



Financial Deficit



Financial Surplus

The total funds required for net lending are shown in Figure 6. There have been substantial erratic year-to-year movements, but there was a strong upward trend in the first half of the 1970's, due largely to house purchase loans and export credit. Finance from the public sector for these purposes has now been reduced, and with the help of sales of assets the government has sought to keep this element of the PSBR at a low level. The sharp rise in 1979 is due partly to erratic factors.

### Reasons for public sector borrowing

The primary purpose of public sector borrowing is to finance expenditure, but there are questions over the kinds of expenditure which justify borrowing and the extent of borrowing which is appropriate. In the private sector it is generally accepted that an enterprise should earn sufficient income to meet all its current expenses, including replacement cost depreciation, and make some contribution towards the cost of investment for expansion. It is difficult to see why a similar practice should not apply within the public sector: if, for social reasons, subsidies for particular activities are thought desirable, grants financed from taxation should be made to the enterprise concerned, and such grants should be treated as part of that enterprise's income. As noted above the public corporations, taken as a whole, have consistently failed to meet this objective, since their earnings (including subsidies) have been insufficient to meet their current expenses. Local authorities' revenue from rates, rents and government grants have generally covered all their current spending, and left something over as a contribution toward investment. Throughout the 1960's the central government raised through taxes more than it required for its own current expenditure, including grants to other sectors of the economy, and this saving rose to a peak in the early 1970's, but since 1975 current spending and grants have exceeded revenue.

Until 1973 saving by the central government was sufficient not only to finance the whole of its own investment but also to make some contribution towards the financing of the public corporations and local authorities: in round numbers about half of the net investment - usually amounting to between 5% and 6% of GDP - was financed by borrowing. Recent experience provides a striking contrast. Public sector investment has been much lower, averaging only about 2½% of GDP in the last 4 years; the public sector has had to borrow to finance the whole of this capital expenditure; and as much again has been borrowed to finance current expenditure.

A clear distinction can be drawn between borrowing for investment and borrowing for consumption. The former increases the potential output of the economy; new power stations increase the supply of electric power, and better houses or improved medical facilities raise the standard of living. It is legitimate to expect people to pay for these services at the time they enjoy them. Borrowing for investment can be regarded as self-financing, with interest and capital to be repaid from the revenue earned or through the effect of the investment in enlarging the tax base. Current consumption, on the other hand, does nothing to increase output or raise the standard of living in future. However, if it is financed by borrowing, whether by issuing securities or money, today's public are provided with claims on future output. People today hope to have their cake and eat it: for they are able to consume more now, by failing to pay through the tax system for the services currently provided, and they expect to be able to consume in future when they sell the securities they have purchased or spend their money. There is a real sense in which public sector borrowing for consumption imposes a burden on future generations.

Persistent public sector borrowing for consumption is therefore difficult to defend. But a good case can be made for public sector borrowing to rise during recessions and fall during booms. For more than 30 years UK governments have recognised that their tax and expenditure policies affect the level of employment, and the maintenance of a high level of economic activity has been a prominent objective. Thus

when recessions were anticipated, governments generally sought to raise the level of public sector spending and reduce taxation; whereas they reacted to boom conditions by raising taxes and cutting expenditure. The effects can be seen clearly in the graphs of saving and investment: for example, in Figure 4, saving by the central government increased sharply from 1968 to 1970 as a result of the government's attempts to stabilise the economy after the devaluation in 1967, and the subsequent decline in saving was prompted by the Heath government's attempt to revive economic activity, and by the Wilson government's response to the world-wide recession brought on by the OPEC price rise at the end of 1973. Similar forces influenced investment by public corporations (Figure 2) and local authorities (Figure 3) until about 1975. It is noticeable, however, that the fluctuations in investment have been very much smaller than those in central government saving.

In principle deliberate fluctuations in investment and saving of this kind have much to commend them, provided that they are seen as part of a conscious counter-cyclical policy, with comparatively low investment in one year being matched by comparatively high in another, so that over the cycle as a whole the level of investment is not curtailed. Indeed, the hope is that by maintaining a more stable level of activity in the economy at large, investment and the rate of growth may both be stimulated. Similarly, if saving is to be low or negative in a recession, it must attain a high positive level in a boom - otherwise the resources which society hands over to future generations will be reduced. In practice it is always much easier politically to cut taxes than to raise them; there is a danger that restrictive policies will lean relatively heavily on investment, whilst expansion will be biased towards consumption. The downward trends in public sector investment and saving since the mid-1960's suggest that this has in fact occurred.

The average level of public sector saving which is desirable - the contribution the public sector should make to financing its own investment and to facilitating investment in the private sector - is a matter for political judgement. It turns on the level of investment in the economy as a whole which is thought to be appropriate, and the contribution which private sector saving can make to it. For many years the level of investment in Britain has been lower than in most of our main industrial competitors, and there has been a consensus that through its economic policies the government should attempt to stimulate a higher level. Until the early 1970's the saving originating in the private sector was also insufficient to provide the finance for investment, and the government therefore supplemented voluntary private saving with compulsory saving through the tax system.

Against a background of inflation and world recession the opportunities for industrial investment are currently depressed; and personal saving is running at a high level. Thus, in cyclical terms, it can be argued that an above-average PSBR is warranted. But there is no case for placing curbs on public sector investment. On the contrary, depressed private investment provides an opportunity for public sector investment to increase. If, for reasons discussed below, it is necessary to reduce the PSBR, the cuts should fall on consumption - public or private - rather than investment. It is therefore difficult to believe that the balance at present between saving and investment in the public sector is right.

#### The effects of a high PSBR

It is often alleged that the high level of the PSBR has led to high interest rates, and that the cost of capital to other borrowers acts as a deterrent to desirable capital expenditure. It is asserted too that the size of the PSBR interferes with smooth control of the money supply, with further damaging effects.

Leaving cyclical considerations on one side there is no doubt that the public and private sector's demands for funds in the capital market are competitive: high public sector borrowing takes place at the expense of the private sector. And, since by and large the capital market operates freely, it is the price of funds rather than rationing which restrains the private sector's demands. For example, industrial companies are unwilling to issue new long-term loans or make rights issues when interest rates and dividend yields are high; and when mortgage rates rise the amount that private individuals can afford to borrow falls.

There are, however, three qualifications that need to be made. First, the PSBR is certainly not the principal cause of high interest rates in Britain today - that dubious honour rests with inflation. Secondly, during a recession a cut in the PSBR might lead initially to a fall in economic activity and a reduction in the flow of saving into the capital market. Nevertheless, interest rates would tend to fall and after some time had elapsed - how long is a matter for heated controversy - private expenditure would pick up to fill the gap. In current conditions, when banks are short of funds to lend to private borrowers and MLR has had to be raised to 17% to discourage private demand, the delay would probably be very short indeed. Thirdly, part of the PSBR, as noted earlier, is due to loans supplied by the government to the private sector and, to the extent that private borrowers would have obtained the funds elsewhere, is not a net addition to the demand for funds. In spite of these qualifications a high PSBR which is maintained for several years, as it has been in this country, generally raises the cost of capital for other borrowers.

The conflict between public and private borrowing is particularly visible in the context of monetary policy. From time to time the government's needs as a borrower have conflicted with their desire to implement a tight monetary policy. When the private demand for credit is strong, government borrowing from the banking system may be inconsistent with monetary control.

Although in practice the government now raises a great deal of money through national savings and other means, sales of gilt-edged stocks still provide a very substantial part of their requirements. Heavy and continuous government borrowing therefore entails regular sales of gilts. It is not always easy for the government to find buyers for its stock: for if economic prospects, particularly the outlook for inflation, are uncertain or if political developments cast a shadow over the financial markets, potential buyers may be reluctant to commit their funds, preferring instead to build up liquidity until the clouds have cleared. But a build-up of liquidity runs counter to monetary policy, since it will be reflected in an acceleration of monetary growth. The government, who cannot therefore afford to wait, has to overcome buyers' resistance, normally by jacking up interest rates to a level which makes gilts seem attractive. Moreover, in a period when the future rate of inflation is highly uncertain, gilt-edged stocks - even with high interest rates - are not a particularly attractive way of holding savings. Pension funds, for example, which are now the most important channel through which long-term savings flow, seek assets which are likely to retain their purchasing power so that they can provide adequate pensions for the members of their schemes, and over a long period property or ordinary shares are more likely than gilt-edged stocks to enable them to achieve this objective. Personal savers, too, generally hold deposits rather than long-term securities, or commit their savings to bricks and mortar which are likely to retain their value. The upshot is that the combination of a high PSBR with a tight monetary policy leads to high interest rates, both to curb the private sector's demand for credit and to tempt savers to hold the liabilities of the public sector.



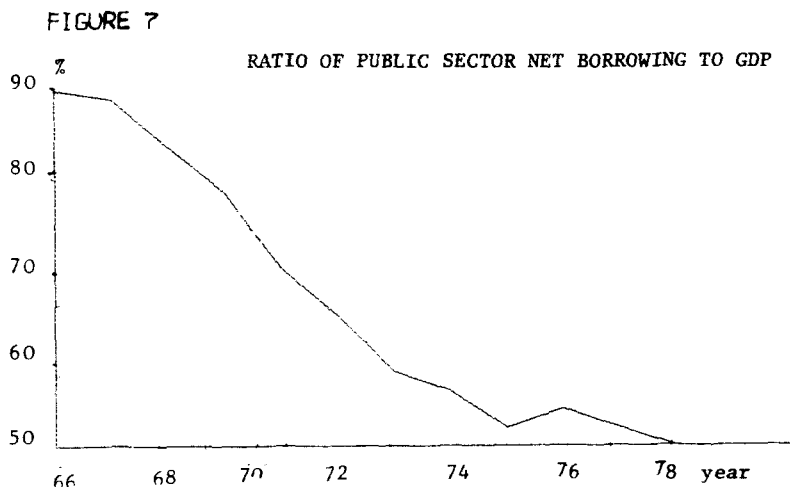
## Inflation and the PSBR

In many countries the government's failure to raise enough tax revenue to finance its expenditure is a potent source of inflationary pressure. This is especially likely to occur if spending is financed by printing money. It is frequently suggested, by analogy, that the high PSBR in Britain is a cause of inflation here.

If a high PSBR led to pressure on resources, so that wages and prices were bid up, there would undoubtedly be a direct inflationary effect. However, it is difficult to argue that this is the case in current conditions, and provided that monetary policy does not accommodate a high PSBR, there is no reason why it should occur at any time. Instead, as has been suggested earlier, the high PSBR will raise interest rates and deter private demand, so that demand in aggregate is not excessive. There may nevertheless be an indirect effect on inflation: for if the high PSBR is at the expense of investment the future productive capacity of the economy will be affected adversely. With less potential growth it will become more difficult to meet workers' aspirations for increased real incomes, and higher wages will be reflected more fully in rising prices rather than increased productivity.

On the other tack, it is often argued that the size of the PSBR has been exaggerated by inflation. In periods of inflation lenders have to be compensated for the declining purchasing power of their capital. The government is therefore compelled to pay more for its funds, but part of the interest payment may properly be regarded as merely maintaining the real value of its borrowing. Indeed, unless sufficient new borrowing takes place, inflation erodes the real value of the national debt.

In fact the ratio of the public sector's net borrowing to GDP has fallen substantially since the late 1960's, partly due to the real growth of GDP but mainly because of inflation. Figure 7 shows that, in spite of the high PSBR, the ratio of government debt to GDP has fallen recently, though much less rapidly than in previous years when government borrowing was less - the ratio fell from 89% in 1967 to 53% in 1975. The fall in the ratio of debt to GDP has almost compensated for the rise in interest rates, and as a result there has been only a comparatively small rise in the net interest paid by the government - from 4% of GDP in 1968 to 4.2% ten years later.



The very fact that interest costs have risen by such a small amount demonstrates that the high PSBR is not a consequence of inflation. Nor would it conveniently melt away if the rate of inflation diminished; the cost of interest payments would fall, but since much of the debt is long-term the process would be long drawn-out. An abatement of inflation would in fact give rise to considerable financing problems for the government, because inflation compels people to save more in order to maintain the purchasing power of their assets, and this element in saving would decrease if prices rose more slowly. Thus the PSBR would absorb a higher proportion of the available saving, and this would reduce the funds available for other borrowers. Moreover, even if the purchasing power of assets is falling the saving required to make good the deprecation of inflation is real enough - it represents consumption forgone by the saver and purchasing power transferred to the borrower. Through inflation the government as a borrower imposes unanticipated or unavoidable losses on lenders. For the government to rely on mulcting the public in this way would be deplorable.

### Conclusion

The trends in the PSBR in the 1970's were deeply disturbing. It is not so much the fact that the PSBR has increased that gives cause for concern. If the PSBR were to increase because the government was acting as a channel through which private saving could flow into investment, a high PSBR might be positively advantageous. But the rise in the PSBR has had no such beneficial cause; it has been associated with a massive decline in public sector saving and a reduction in public sector investment. Throughout the 1960's governments followed fiscal policies which enabled them to augment the savings of the private sector and provide additional resources for investment; whereas by the end of the 1970's the government was siphoning off part of private saving for conversion into current consumption.

On a medium-term view there is a need for a substantial increase in the level of investment, in both the public and private sectors, in Britain. Recovery in the private sector may have to await an improvement in the general economic situation, though a fall in the cost of capital for industry would help. But the scale of public sector investment is in the government's hands, and while the rewards for further investment in some activities may be questionable, there is ample scope for larger investment programmes in some areas, eg the energy industries, transport, and other aspects of social infrastructure.

Higher investment by the public sector alone points to the need for a change in the balance between consumption and investment in public sector spending, or to an increase in tax revenue to pay for what is currently consumed. But a recovery in private sector investment will compel the government to go even further - to cut borrowing for its own purposes, not merely to change the balance within the PSBR. A reduction in the PSBR will be even more necessary if, as is probable, private sector saving falls when inflation is brought under control.

A change of course in public policy has already taken place. The current account subsidies paid to some of the public corporations are being controlled, and after taking them into account public corporations are being required to operate at a profit and make some contribution to financing their own investment. The balance between taxation and expenditure of the central government is being altered; and revenue from North Sea oil and gas will help. But if investment in the public sector and the PSBR are to return to the levels of the 1960s, public sector saving needs to rise by more than 5% of GDP - about £10,000 million at current prices. This is a daunting task, and one whose magnitude is not yet generally appreciated.