



The Fiscal Deficit and National Debt: Can we get it right once and for all?

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This document is a follow up on our [Letter to the Economic Team](#).

We continue reading reports in the newspapers that raise concerns about our increasing national debt. This leads to dramatic statements, as if we were reaching judgement day; including the fallacy that each Filipino owes (but to whom? See below) over P130,000. Recent news articles continue to reinforce the notion that domestic borrowing crowds out private capital formation. They also frequently discuss the internationally-accepted thresholds for the fiscal deficit-to-GDP and debt-to-GDP ratios (about 3% and 60%, respectively) which do not have a solid theoretical basis to begin with.

Other concerns usually cited include the idea that debt servicing diverts government funds from more meaningful public programs, or that government “borrowing” from the private sector must be allocated efficiently to ensure that economic growth outpaces the increase in the debt stock. These views often lead to the misunderstanding that the tax base must then expand in order to absorb any economic shocks that could compromise the country’s economic performance.

To add to these flawed narratives is the government’s continued emphasis on “fiscal consolidation” as a central feature of its medium-term strategy, as reiterated in the recent 191st Joint Statement of the Development Budget Coordination Committee on the review of the fiscal program ([191st DBCC Joint Statement on the Review of the Medium-Term Macroeconomic Assumptions and Fiscal Program for Fiscal Years \(FY\) 2025 to 2028](#)). We question the true meaning of the term “growth-enhancing fiscal consolidation,” especially since official growth and income per capita targets have consistently been missed, and this fiscal strategy is tied to, as noted above, thresholds with little theoretical justification. Aiming to achieve the current (and revised) deficit-to-GDP and debt-to GDP ratio targets may, in fact, be causing more harm than good.

We have already written that these concerns are, for the most part, misplaced (e.g., [National Debt and the misleading family metaphor: A message to the economic managers and journalists](#)).¹ The departments of Budget, Finance, and Treasury, as well as the central bank (Bangko Sentral ng Pilipinas -BSP), are plain wrong when analyzing the public sector’s finances as if they were those of a family or of a firm. Perhaps some actors in the private sector (in the banking sector in particular) are also at fault because they should know better. We also believe that the technical staff advising our legislators, as well as the Economic Committees of Congress and Senate, should rethink their views

¹ A more technical explanation is provided in: [How ‘Monetization’ Really Works — Examples from Three Asian Nations’ Responses to Covid-19](#). This includes an analysis of how the BSP directly financed Treasury in 2020 to fight COVID-19.

about how the finances of modern economies work. Finally, journalists (though for the most part they are not trained economists) should make an effort at understanding the government and central bank's operations and accounts, so as to improve the quality of their analyses and reporting. All this matters because the Philippines is still a lower-middle-income country with a GNI per capita of barely US \$4,500. Policy mistakes are much more costly for us than for an advanced economy.

We offer below a primer of how the government's finances operate and the role of the central bank (BSP). It is just the operational reality, not a model. We hope it is written in such a way that most people with basic background knowledge understand it. We conclude with some implications for the nation's development:

1. Reality 1: Government spending (G) is reflected in the government system of accounts as a transfer to the private sector. When the State spends by creating new money, the assets of the private sector increase without a corresponding liability, which means a higher net wealth for the private sector.
2. By spending, governments create money, that is, the money supply increases. Many view this act with suspicion, and leads to all sorts of claims about (hyper)-inflation, increase in interest rates (increase), private sector crowding out, monetization, lack of fiscal space, etc. They are wrong because the explanations do not accord with the reality. We add here that the other source of money creation (the most important one) is commercial bank lending (loans create deposits). Demonizing money creation is tantamount to not understanding how economies work.²
3. The fiscal position of a country is the difference between the taxes (T) collected from the private sector (e.g., $T=P50$) and government spending (G) on infrastructure, education, health, civil servants' salaries, etc. (e.g., $G=P100$).³ If ($T>G$), as in this

² This is reminiscent of the old monetarist doctrine (Milton Friedman) and the quantity theory of money. This is history. Central banks today do not target the money supply because they cannot control it. By "control" we mean that central banks cannot set and adjust its level or growth path directly and predictably, using their own instruments. The quantity of money in the economy depends on the decisions made by the government and private banks. Indeed, the money supply in modern economies is not under the control of central banks, but is determined by borrower demand for bank credit. Mainstream analyses take the view that central banks have it in their power to initiate exogenous changes in the nominal supply of money. This view maintains that monetary change originates in changes in the high-powered base, which allegedly are under the control of the central bank. We, instead, contend that the supply of credit money is endogenous and responds to changes in the demand for bank credit. Central bank open-market operations affect how required reserves are supplied between borrowed and nonborrowed reserves, rather than the total volume of reserves that is endogenously determined. Our view is that the central bank has the ability to set exogenously the supply price of the money market, but not the quantity of credit money. To control inflation, central banks like BSP target the overnight interest rate.

³ In the Philippines, taxes are collected through the Bureau of Internal Revenue (under the department of Finance) and expenditures are managed, authorized, and disbursed, through the departments of Budget and Treasury.

example, the government will run a fiscal deficit (in this example, $(T-G) = -P50$). The government's deficit (-P50) is matched by an equivalent increase (+P50) in the accounts of the private sector (those who received the payment). Therefore, a fiscal deficit implies, peso for peso, that the government sector has contributed to creating wealth in the private sector.

4. Reality 2: Governments do not “use” taxes (T) to spend (G). Government spending takes the form of electronic transfers (or a signed check) from the Philippine Treasury to bank accounts, to the recipients of this government spending (e.g., a construction company to build a school). Ask the Budget and Treasury departments.⁴ These transfers are “reserves” (the technical name of the money used in the banking system) created by the Bangko Sentral ng Pilipinas (BSP) (the government's banker) to supply money to the government. BSP creates money *ex nihilo*. This means that education, infrastructure, health, civil servant salaries, etc. are not paid with our taxes. In other words: taxes do not “fund” or “finance” government spending. BSP and our government do not need our taxes. We understand that this may sound strange to many after being used to the mantra that governments need to collect taxes to spend, like a family. Even policymakers in the economic departments believe it. However, the reality cannot be further from this. It is also a matter of logic: government needs to spend first (create money) and put money in the pockets of the private sector.

5. Two additional important points about taxes (T): (i) they remove currency from the economy. They destroy previously created money, that is, they decrease the supply of money; and (ii) they are important to regulate demand, and to disincentivize *bad*s like smoking or driving to avoid traffic jams.

6. The previous points mean that the notion that the government has a budget constraint like a family (and the possibility that it will “run out of money” if $G > T$) is incorrect. Governments use *fiat money* to make their payments. They have as much as they want to....although this does not mean that they have to spend as if there is no tomorrow. Our claim is that often-heard expressions such as “the government does not have resources” (the domestic currency is not a resource because it is not scarce), or “the government does not have fiscal space”, are wrong. So, yes, the Philippine government can *financially* afford the public goods that we need, as well as address child malnutrition. It may have some *real* constraints (e.g., no company can supply materials to build a school) but not financial (lack of pesos).

7. Why do governments issue so-called debt then? Debt plays a very important role in a modern economy but as a monetary operation. In the standard rhetoric, the private sector finances the government. This is incorrect. To explain why governments issue debt, note that a fiscal deficit ($G > T$) effectively implies excess liquidity in the banking system.

⁴ Our simplified summary is technically correct, even though, in practice, payments require several steps that involve the Departments of Budget and Treasury with different levels of authorization and documents.

This is because taxes and government spending are mediated through the banking system (you pay taxes out of your bank account and the government makes a payment to somebody's bank account).⁵ Banks cannot have excess liquidity at the end of the day (they are profit maximizing companies). Of course, not all individual banks may have excess liquidity. Some of them will need it and they will borrow from the banks that have excess. But at the end of the day, if there remains excess liquidity in the overall banking system, it will put downward pressure on interest rates (yes, a government deficit puts downward, not upward, pressure on interest rates) and drive them to zero.

8. The BSP cannot allow this because, otherwise, the overnight interest rate (BSP's policy rate), the tool it uses to achieve its inflation target, would go down to zero. Thus, BSP needs to mop up the excess liquidity from the system to maintain the policy rate within the stated band or corridor.⁶

9. How does it do it? Many central banks coordinate with their Treasury departments to issue bonds and offer them, first to the primary dealers (major banks), in exchange for the liquid funds they have (which earn zero interest). The primary dealers bid against each other to buy the bonds. In the case of the Philippines, the Bangko Sentral ng Pilipinas (BSP) issues its own debt instrument, called Term Deposit Facility (TDF) to conduct Open Market Operations. Therefore, Treasury debt is irrelevant for liquidity management purposes. All bonds do is to offset operating factors at the Central bank. The BSP's TDF is a key liquidity absorption facility used for liquidity management. The TDF is used to withdraw a large part of the structural liquidity from the financial system to bring market rates closer to the BSP policy rate.

10. Reality 3: Bonds in the hands of the private sector (the latter's wealth) are, peso for peso, the other side of the government's debt. Bonds are just a portfolio choice offered to the private sector (non-government sector) to store or save some wealth (surplus money recycle when the government creates money) as a risk-free asset.

11. The exchange of liquid funds for bonds (portfolio choice) is of course a great deal for those that have excess liquidity earning zero. The government will honor its "debt" (denominated in pesos) and will pay interest. This interest is part of the disposable income

⁵ National government agencies operate primarily through government servicing banks, especially Land Bank and the Development Bank of the Philippines. Private banks may participate in some government-related activities, but not as primary payment channels for official disbursements. In practice, a government agency, e.g., the department of education, will process the payment (e.g., to a construction company to build classrooms) through Land Bank, as it is the government's servicing bank. Then Land Bank will issue the payment either by crediting the contractor's Land Bank account, or by issuing a check payable to the contractor, which the contractor can deposit in any bank.

⁶ What commercial banks and central banks do vary depending on how the latter carry out daily operations, using a version of either a *corridor* or a *floor* system, to achieve the interest rate target. BSP uses the corridor system.

of the bondholders, hence income that the private sector will use to, for example, consume.

12. How does the government pay this interest? The same way it makes any other payment: through electronic transfers to the accounts of the bondholders.

13. To stress: Bonds are referred to as “debt” from the point of view of the government; but they are “wealth” from the point of view of the private sector, peso for peso. So, when one reads in newspapers that national debt is almost P17 trillion, one can equally say that the Philippine private sector owns almost P17 trillion in bonds. They are equivalent statements. We hope this makes it clear that the statement that each Filipino owes over P130,000 is ludicrous.

14. You do not want debt (=government-issued bonds)? Ask the bondholders (largely the private sector banking system) to return the bonds and do not issue more. This would cause havoc in the banking system and in BSP. Fiscal deficits provide stability to the financial system. Another option, more sensible, not to have debt is for BSP to offer interest on reserves, that is, to offer commercial banks the possibility to deposit their excess liquidity in a special account (at BSP) that pays interest. No more bonds.

15. Reality 4: Who pays for the bonds when they are issued? The natural answer is: the private sector. However, this is the wrong answer. Why? Do not forget that the government had already advanced the funds to the private sector by way of the fiscal deficit, a transfer to the private sector (fiscal deficit=private sector surplus=P50). Thus, effectively, the government pays for the bonds. It should be clear by now that the Philippine sovereign government does not borrow from the private sector.

16. This process (government spending and bond issuance) is, in general, non-inflationary though it could be. This could happen when G contributes to getting the economy to full employment (firms working at full capacity). At that point, firms will raise prices. The solution to this situation is to tax people (consumers). This is not how inflation happens in the Philippines. Most often, our inflation is due to supply bottlenecks and it occurs before the economy reaches full employment.⁷

17. There are up to four types of debt that are often mixed: (i) depending on the issuer: public and private; and (ii) depending on the currency in which it is denominated: domestic or foreign. What debt is potentially problematic? All private debt, and all foreign-currency denominated debt.⁸ The former because the private sector is the one that may default. The latter (which a government may certainly need) because in order to repay it, we will

⁷ Recall that firms (e.g., supermarkets) set and increase prices. The latter (increase in prices) is inflation. This does not happen because the government has thrown bills out of a helicopter and millions of people rush to the supermarket.

⁸ The Bank of International Settlements (BIS) has debt thresholds (% of GDP) for household and corporates, above which they are detrimental for growth. These are 85% for households and 90% for corporate.

have to earn the corresponding foreign currency (e.g., buy dollars). The Philippine Treasury issues foreign-currency denominated debt but this represents only about 30% of the national debt. The other 70% is peso-denominated. Public debt in domestic currency is never an issue unless the government makes a political decision not to honor it. But this will never be a matter of affordability. As far as we know, the Philippine government has always honored its peso-denominated debt. Remember: private debt is a liability of the private sector. Public debt is an asset of the private sector.

18. Analyzing (T-G) in isolation, as the Departments of Budget and Finance do, is a misleading exercise. This is because there is an accounting identity that links (T-G), the financial balance of the public sector, to the balances of the external sector (CA, the current account) and of the domestic private sector (S-I, where S denotes savings and I investment). This relationship is: $(S-I) + (T-G) - CA = 0$. This identity is true for all countries. The real problem of an economy (what leads to crises) is when the private sector balance goes into deficit. The simplest way to understand the implication of this identity is to assume that $CA=0$: the only way for the private sector to run a surplus ($S>I$) is if the government runs a fiscal deficit ($T<G$). Budget surpluses ($T>G$) imply that households have to sell securities so that they can pay for their taxes. Their net financial assets and savings go down by the amount of the surplus. Beware of a fiscal (budget) surplus. It is deflationary, as it takes funds away from the private sector's pockets. This will affect disposable income. Fiscal consolidation is not growth enhancing.

19. What does this mean for the Philippines? For a nation that typically runs a current account deficit ($CA<0$) and whose private sector desires to run a surplus ($S>I$), the only solution is if the government runs a deficit ($T<G$), to make the identity hold. The implication is that the Departments of Budget and Finance, cannot decide the nation's fiscal balance. This will be “decided” by the private sector, and the government will accommodate it. No wonder the Departments of Budget and Finance revise the fiscal deficit. All they are doing (without understanding it) is to follow (accommodate to) the private sector's choices and decisions. Given this, it is difficult to understand the government's quasi-obsession with fiscal consolidation.

20. It is also true that at the end of the day (that is, *ex post*), government spending (G) will be identical to the sum of taxes (T) plus the change in the stock of public debt (ΔB) plus the change in the monetary base (ΔM), where the latter is the Government's net position with respect to the banking sector, i.e., $G = T + \Delta B + \Delta M$ (B stands for bonds, M is the monetary base, and the symbol Δ denotes change in the variable, so in this case it refers to new debt and new money). This is not a (budget) constraint. This implies that: $(G-T) = (S-I) - CA = \Delta B + \Delta M$. The interpretation of these accounting identities is that, given the private sector decisions (spending, saving, trade flows), the government can allow its balance to adjust to whatever magnitude is required to maintain full employment and price stability. If $CA<0$ and $(S-I)>0$, the drain on aggregate demand would require the government to run a deficit $(T-G)<0$ of sufficient size to ensure that total spending is

sufficient to absorb the real productive capacity available in the economy. Of course, if the non-government sector does not want to net save, it will then increase spending, tax revenue will increase and there will be no budget deficit.

Implications for development:

21. Not understanding the above leads to incorrect statements and ineffective policymaking – which may unintentionally hinder development efforts. If they were not correct, you would have to wonder why the American and Japanese economies run and run, despite having fiscal deficits and debt-to-GDP ratios much higher than those of the Philippines. We are not claiming that the Philippines should run a higher fiscal deficit for the sake of doing it. All we have done in the previous paragraphs is to describe the monetary and fiscal reality of modern sovereign economies like ours. Given this reality, we have argued that the Philippine government could provide the public goods we so much need without resorting to erroneous arguments. In the United States, President Donald Trump has launched a tax cut that will lead to a debt-to-GDP ratio of 124% in 2034. Our bet is that the American economy will not collapse.⁹ In the case of Japan, debt at 200% of GDP has been the result of decades of fiscal stimuli needed to activate the economy. The Japanese economy has not failed as a result of the fiscal deficit (the opposite, the deficit sustained it), and interest rates and inflation have not skyrocketed. Wasn't in fact the Japanese government desperate to generate inflation (in a country with deflation)? The fiscal deficits have not done it.¹⁰

22. Key departments like Budget and Finance, as well as Congress and Senate, operate (when they discuss the budget) within an extremely narrow mindset. They believe “pesos” are a scarce resource (bad economics); and they do not realize that Treasury makes payments by crediting accounts or issuing checks -nothing to do with using taxes. They think as if they were firm or household accounts, that is, that $G > T$ is a fiscal deficit

⁹ We acknowledge the recent Martin Feldstein lecture by no other than Harvard's Greg Mankiw, “[The Fiscal Future](#).” Yet, we hope that those who watch the video realize that the prediction that debt is unsustainable is not new (worse for Japan, with a higher debt ratio), and that they catch some obvious mistakes (e.g., about past sovereign defaults, why Zimbabwe's hyperinflation, and about the overall understanding of the effect of deficits and debt on interest rates and inflation) - apart from the fact that here refers to the United States. And notice that Mankiw does not know “how” and “when” the US debt-to-GDP ratio will stop growing.

¹⁰ The rating agencies Standard & Poor's, Moody's, and Fitch have downgraded the US and Japan several times. This shows poor understanding. We were told once that the Philippine government fears downgrading by the agencies. The best way to counter the agencies' negative views of fiscal deficits and debt, apart from counterarguing correctly, is to build a more robust economy. See our [Letter to the Economic Team](#).

and the government needs to beg the private sector to finance the difference. This is incorrect.¹¹


23. That we argue that the Philippine sovereign Government is not financially constrained when it uses pesos, does not mean that we are suggesting that it should spend irresponsibly. We have already argued that the limit is full employment, at which point, further spending would trigger inflation. Apart from this, there could be real constraints and government capacity to execute programs. What we argue is that we often read or hear statements that make no sense. It is not true that our government “does not have money” to improve our infrastructure, education, and health systems, as well as take care of malnutrition, almost *ipso facto*. We have learned that the Department of Education has estimated that the country has a shortage of 165,000 classrooms, and claims that the cost of building classrooms increases as population increases. The truth is that when a government announces in its budget that it will spend P100 million, for example, on a new project, that figure does not reflect a cost. *The real cost of any program is the extra real resources that the program requires for its implementation*. For example, if the government were to build new classrooms, the real costs of the program would be the new materials needed and the extra capital equipment that the companies and workers contracted would use. In other words, government programs have to be appraised by how they use real resources rather than in terms of the nominal money values involved.

24. Consequently, it is not true that the government needs to collect taxes to spend, or to enter into Private-Public Partnerships (PPPs) with the private sector (which might make sense in some cases, but not because the government cannot fund its programs).¹² Today’s advanced economies took care of these problems long ago, even in the first part of the 20th century. They certainly did not pay for the public goods they provided with taxes collected in advance. The same is the case today, when they continue adding public goods (improving their roads, subways, public hospitals and schools, etc.): they make payments to the companies that provide those public goods; this generates a fiscal deficit; bonds are issued to mop up the excess liquidity; and life goes on. That is why so-called debt (from the government’s side) increases; so that the wealth of those who own the bonds. Yes, doomsayers predict Armageddon from time to time. Yet, we are still here.

25. We end with a plea: let us not be fooled by old taboos about deficit spending and debt, and about naive arguments about taxing and spending. It is about time that our economic team stops using a language that does not correspond to the reality. As an example, see the Bank of England’s document: [Money creation in the modern economy](#).

¹¹ By “incorrect” we do not mean the accounting of taxes and government spending, which is certainly necessary. We refer to the fact that the economic implications are neglected or misunderstood.

¹² We are intrigued about how the PPPs in the education sector to build classrooms work: what do they entail, given that, no matter what, the government will pay private-sector construction companies to build them? Isn’t this what the government always does? Or is it some sort of gimmick to pretend that this does not affect the budget?



In the same vein, Congress and Senate technical staff advising our legislators, as well as the Chairs of the Economic Committees of both Houses, should make an effort at understanding what Budget, Finance, Treasury, and BSP do in practice, instead of relying on conventional textbook models that require updating, and act consequently when they discuss the budget. Old habits die hard. We understand that policymakers have been trained to think in a particular way, and that old habits die hard. Likewise, financial sector specialists should explain, for example, what they do when they participate in bond auctions. Educators and academics should also make an effort to understand the monetary realities of the economy, rather than depend solely on outdated narratives. It is our responsibility to ensure that we do not pass on misconceptions to the next generation. Finally, we urge economic journalists please report properly and stop playing doomsayers.