Funding the Future

The economics of Scottish taxation

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I have already written about what I think the foundations of Scottish taxation should be. This thinking is based on a report I have submitted to the Finance and Constitution Committee of the Scottish parliament in anticipation of a hearing on 19 April. In that post I referred to the economics that underpins those foundations and said I would write separately on the issue, and now duly do so.

In my submission I say that the foundations of Scottish taxation must reflect

* Modern taxation theory;
* The role tax now plays in economic policy;
* The social and economic priorities of the society that imposes the charge.

The first of these is my concern here. As I say in my submission:

To build appropriate foundations for a tax system the role of tax in the economy and wider society has to be properly understood. It is my suggestion that this is rarely the case. Just as the Bank of England had to say that the role of banking had been almost wholly misunderstood by economists and was incorrectly represented in almost all economics tax books in 2014[1], so too is tax widely misunderstood.

It is widely thought that tax is necessary to pay for government provided services. It has, however, recently been realised that this is not true. This is because all government services can *in principle* be paid for either by printing money or by QE operations (which amount to much the same thing).

The reality is, of course, that no government would want to pay for all government services this way. That is because the result would undoubtedly be rampant inflation. This though does not, however, change the principle: that principle is that all government services can be paid for without taxation.

What is more, if the proverbial 'chicken and egg' question of which comes first with regard to government spending or taxation is asked then it must be government spending. If government did not spend first then none of the currency it insists be used to pay the taxes it demands be paid would actually exist. The fact that much of the money in question has no tangible existence and is only in an electronic bank accounts does not change this conclusion: those banks and the accounts that they operate only exist under a licence granted by the government.

Appreciation of this fact demands a whole reappraisal of the role of tax In the economy, just as happened when the Bank of England said in 2014 that the awareness that it was lending that created bank deposits and not savings that permitted lending demanded a whole reappraisal of the role of money in then economy.

[What is clear is that if] tax is not required to pay for government provided services it must have other reasons for existing. There are six of them:

* ***Reclaiming the money the government has spent into the economy.*** It may appear that tax revenue is being used to pay for government services supplied but that is not true: the service comes first and the tax comes second. Tax reclaims the money spent to prevent inflation. The amount reclaimed is that which is considered sufficient to leave the desired rate of inflation in the economy. Because we may well want some inflation - and that usually requires that more money be created than be reclaimed by tax - balanced budgets are usually a bad idea for the macro-economy because they deny the economy the cash it needs to function in a mildly inflationary environment.

* ***Ratifying the value of money.*** Because a government requires that tax be paid using the currency that it creates, and uses when undertaking its own spending, that currency has for all practical purposes to be used in the economy for which it is responsible, assuming that tax forms a significant part of people's liabilities. Tax does, therefore, give a currency its value in exchange and as a result provide control of an economy to the government that charges it.

* ***Reorganising the economy.*** Fiscal and monetary policy are the two fundamental tools available to a government to manage its economy, assuming it has its own currency. As the previous analysis has shown, money creation and taxation are the flip side of each other. Tax is then an integral part of macroeconomic policy and so of reorganising the economy to meet social and economic goals.

* ***Redistributing income and wealth within the economy.*** Experience has shown that market economies are very good at concentrating income and wealth in the hands of a few people in a society whilst economics makes clear that this is harmful to the prosperity of society because it seriously reduces overall levels of demand in the economy. Redistribution of income and wealth is then an essential function that any Government must undertake and appropriately designed taxes are a proven and effective method for delivering this policy.

* ***Repricing goods and services.*** Markets cannot always price the externalities of the goods and services they supply or reflect social priorities. Tax permits repricing of

goods and services to reflect these facts.

* ***Raising representation in democracies***. There is little doubt that tax motivates interest in the democratic process. When people recognise that they pay tax they are more interested in engaging with the electoral process.

The foundations for Scottish taxation that I propose are based on this economic logic. It is a logic that could liberate Scotland to become a fully economically literate and functioning state and truly equip it for independence.

[1]
http://www.bankofengland.co.uk/publications/Documents/quarterlybulletin/2014/qb14q102.pdf