

The chicken and the egg of tax and spend - or is it spe...

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There was a lot of debate on fractional reserve banking on this blog earlier this week. Some still maintained, despite all the evidence to the contrary now, that banks need deposits before they can lend. They don't: the loans come first, and that now radically transforms our view of savings, and much else.

As I have also argued, this is also the precursor to the new view that is required of tax and spending. For decades Labour has been accused of being the party of tax and spend. Except that's impossible because no government with its own currency taxes and spends. They always spend and tax. How do I know? The proverbial chicken and egg conundrum provides the answer.

First some simple facts have to be understood. The UK government requires that you make payment of your tax in pounds sterling. Nothing else will do.

Second, where do those pounds you have to pay in come from? If it's notes and coins the answer is obvious: the government permits their production.

But what if the currency in question is just an entry in a bank ledger? Here the answer is only slightly more complex. As the Bank of England admitted in April 2014, all deposits in bank accounts are the result of loans made: the loans create the money that is then deposited. And who permits banks to make loans? The government does; a right it jealously guards because it preserves its right to control the creation of money the right to create money. In other words, commercial banks do create money, but under licence from the government.

And how did the government start this ball rolling? Did it just create a pile of money and give it to people so they could pay their tax? Hardly: that would have been pretty pointless, wouldn't it? Instead they spent the money into existence. Notes and coins existed because the government had bought something with them, and promised to make repayment of the debt they represented (which notes still say they will) on demand.

In practice they discovered they did not have to fulfil the promise. They just demanded payment of tax instead using the notes and coins they had created. When the tax was paid the debt was, in effect cancelled, even if the tokens (money) were then used to start the process all over again.

So does government tax and spend? No, and it never has. Governments with their own currencies always spend and then tax.

Realising that is staggeringly important.

First it means that you do not need tax to spend.

Second, it means that the amount of tax you can collect is largely dependent on the amount of spending a government undertakes, which is the reverse of normal logic. So if you want to answer the question "where does the money come from to pay for this?" the answer becomes "from out of what's just been spent."

Third, it means that tax is not about paying for spending at all: it is instead about cancelling the impact of government spending to prevent inflation. This means that so long as there is little or no inflation there is no reason at all for a government to balance its books.

Fourth, in that case tax has to also be instead be about fulfilling social policy in all its dimensions.

Tax is in other words something very different from what most people think it to be. And the last thing it is about is paying for spending.

When we realise this the UK (and other countries) will be liberated to achieve its potential. Until then outmoded ideas will constrain us in a wholly unnecessary economically distressed state because we base our whole macroeconomic thinking on something that is fundamentally untrue.

I wait for a politician to stand up and say it.