Funding the Future

The NHS does not require a hypothecated tax: it needs a...

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The FT says this morning that:

The latest winter crisis to hit the NHS – and the knowledge that an ageing population will only intensify such pressures – is prompting revolutionary thinking by tax policy experts, who are re-examining the discredited idea of earmarking increases for specific public spending priorities.

Known as hypothecation, it has already received the grudging backing of a former top Treasury official. Other former critics of the concept remain dubious about the idea but admit its time may have come.

With the public sceptical about the ability of politicians to act in their interest, but increasingly accepting of the need for more taxation to fund public services, politicians are keen to link revenues to specific items as a way to increase spending transparency and make tax increases more palatable.

I regret to say that my reaction was threefold. The first was to think that of these 'tax experts' don't understand how tax works. That is because they clearly seem to think tax pays for government expenditure when that is not true. To be a tax expert and not understand what tax does is pretty worrying.

Second, I thought that these people also do not understand macro economics in which the funding of government spending can be formally summarised as:

G = T + âˆ†B + âˆ†M

Where:

G = Government spending

T = Net tax receipts

B = Borrowing (and so âˆ†B is the change in borrowing in a period)

M = Government created money (and so âˆ†M is the change in that sum during a period, which covers QE).

As is obvious from this expression, there is a relationship between tax and spend, but it is not direct.

And third, I felt that these experts would be doing real harm if they carried on with their misconception that tax precedes spend when that is not true, and will both constrain the NHS and harm the economy whilst doing so.

Let me explain. As I argued in my White Paper on Scottish Taxation, but in a fashion that has general application:

It is in fact the way in which all government spending is initially incurred. It is always true that the government has to spend before tax can be paid. That is because unless the government did spend the money that it wants to be the legal tender of a state into existence then there is no way in which that currency would then be available to make payment of the tax that it demands, liability for which is only ever stated in its own currency. This, incidentally, also explains how the promise printed on a bank note — that the central bank promises to pay the bearer on demand the value of the note — is fulfilled in the modern economy. The promise is fulfilled when tax is paid.

As I then explained:

So why the reference to 'magic' that so money politicians like to make of what happens in the economies for which they are responsible? There are three reasons. First, this system of government control of the tax and monetary system is relatively new, and is not always believed as a result. It only really came into common use when the USA left the gold standard, which backed up the value of money via a fixed rate of exchange to gold, in 1971. Second, it took a long time for people to realise the implications of this change, an understanding of which is only really becoming commonplace now. And thirdly, since 1979 in the UK and 1980 in the USA there has been a dominant political culture that has suggested that government spending must be constrained. If it was widely known that this spending could be funded without the use of tax (the hatred of which was simultaneously fuelled by this culture) then the whole myth on which neoliberal economic thinking is based — which says that states can't afford too much government spending — may have been shattered. No wonder it was said that there was no such thing as a 'Magic Money Tree': the bigger the lie the more likely it is to be believed.

And added:

All that being said, the reality is, of course, that no government would want to pay for all government services out of new money being continually pumped, without limit, into the economy. That is because doing so would undoubtedly result in rampant inflation.

This fact does not, however, change the principle: that principle is that all government services can be paid for without taxation. This, then, also answers the proverbial 'chicken and egg' question of which comes first: is it ‘tax and spend’, or ‘spend and tax’? By now it should be obvious that the correct answer is that there can be no such thing as tax and spend; the only obvious answer to this question is that there is always spend and tax. In other words, governments can always spend to create the public services they think appropriate using new money created for the purpose and it is the role of tax to reclaim that money from the economy to prevent inflation. The answer to the question of ‘how are you going to find the tax to pay for the spending you plan’, so often posed to politicians, is a simple one: it is to say that it is the spending that creates the capacity to pay the tax in the economy. To put it another way, the spend pays for itself. Appreciation of this fact demands a whole reappraisal of the role of tax in the economy, just as the Bank of England *revelation in 2014 that it was lending that created bank deposits and not savings that permitted lending demanded a whole reappraisal of the role of money in the economy.*

So, the reality is:

1) Spend comes before tax, always.

2) This has to be true: if it wasn’t there would be no money to pay the tax with.

3) Government spending does, then, create the capacity to tax.

4) But tax is only required if macro economic conditions, and most especially inflation, demands it. Otherwise the spend should be covered by borrowing or money creation.

It really is time some tax experts, and the FT, learned this. The safety of the NHS might require that they do.