Funding the Future

From modern monetary theory to modern taxation theory:...

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I had a paper published by the Real World Economic Review in the last few days. This is on modern monetary theory and taxation. The link is here: I would add that signing up to get access is not that straightforward in my experience, but that might just be me or my browser.

The abstract of the paper as submitted says:

Modern monetary theory (MMT) has played an important role in advancing understanding of the economic function of taxation, including by showing how it acts to 'cancel' government spending as part of a spend-tax cycle. To date however, MMT has not fully explored the implication of these insights for how tax can also achieve social, economic and fiscal goals, as well as macroeconomic ones. This omission is addressed in this paper by suggesting that cash paid in tax is a residual figure arising from a plethora of decisions on tax bases, reliefs and allowances, as well as tax gaps that result from non-compliant taxpayer behaviour. The impact of this range of decisions and practices can be interpreted as a form of social policy with distributional and economic consequences. Such decisions and practices require systematic estimation and appraisal, as well as conscious management of their consequences, if effective control of the economy is to be maintained. It is suggested that this process can be supported by a modern theory of taxation (MTT) that, building on the understanding derived from MMT that tax is not a tool for government revenue maximisation, can deliver new perspectives on the use of tax as a critical instrument in economic and social policy management.

I am aware that almost anything written on modern monetary theory appears to be contentious, and that there are those who to seek to belittle my own contribution. I should then add that Randy Wray has already written to me about this paper, welcoming it and the contribution it makes to MMT thinking. Those seeking to dismiss it because I wrote it should, then, tread warily I suggest.

That said, I am aware that I have raised difficult issues, but I hope without offending too many. Suggesting that one of MMT's major contributions is to reverse the understanding of the revenue cycle will, for some, be contentious: they will place the emphasis elsewhere. But that is not key to my argument.

What is key is that if MMT is to be a tool for macroeconomic management, which is what I suggest it is, then its ability to forecast, and take action to prevent, inflation is critical. In that context the appropriate balance in this equation is vital:

G = âˆ†B+ âˆ†M + T

where G is government expenditure, T is the sum total of taxes raised in cash during a period, B is government borrowing and M is government created money, with âˆ† representing the change in a total during a period.

I hope and suspect few would argue with the fact that this is the identity that explains how a government is funded in cash terms. Few would also doubt the significance of tax in it. The argument in my paper is that to presume T (cash recovered by tax) is manageable in its own right is wrong. Instead I suggest:

The reality is that T in this formulation is a residual figure i.e. the tax paid in cash is only settled after a whole range of other issues have been addressed and their value has been assessed. So, as is noted below, T is influenced by decisions on the tax bases that should actually be subjected to taxation, decisions on rates and allowances to be provided, and taxpayer decisions on the degree to which they will be compliant with the demands made of them. It is not, then, the case, that a decision can be taken in isolation on the sum of tax to be collected: these other factors have to be taken into account in forecasting the sum likely to be recovered from the economy.

The result is that I argue that:

In this context an appreciation of the tax gap is important. Both the IMF (2013) and the European Commission (TAXUD 2018) argue that net tax collection arises after the deduction of two broadly stated tax gaps that reduce total potential gross tax yields i.e.

T = Tt - Tf - Tc

where Tt is the total potential tax due on the tax base, Tf is the net tax foregone as a result of policy decisions and Tc is the tax compliance gap. Both terms require expansion. In the normative typology of the tax base that the IMF (2013) suggests be used for estimation of tax policy gaps:

Tt = (Tb x Tr)

where Tb is the tax base for a particular tax and Tr the standard tax rate for that tax base, and:

Tf = Tp + Ts

where Tp represents the value of tax bases not taxed as a consequence of a policy decision (e.g. wealth) and Ts represents the value of allowances, reliefs and varying tax rates granted within bases that are taxed to encourage varying taxpayer behaviours by way of tax spends, whilst:

Tc = Te + Ta + Tu

where Te is the part of the tax compliance gap resulting from illegal tax evasion; Ta is the part resulting from the avoidance of those tax obligations that a legislature thinks fall on taxpayers and Tu is the part of the tax compliance gap resulting from non-payment of tax debts, or unpaid taxes.

Substituting this understanding in the equation for G:

G = âˆ†B + âˆ†M + ((Tb x Tr) - Tp - Ts - Te - Ta - Tu)

This version of the identity previously noted suggests that the task of using tax to manage inflation, whether before or after it emerges into an economy in the fashion that MMT suggests possible is more complex than the basic identity implies. This is because what this identity makes clear is that the variable T — the tax settled in cash during a period - is the residual of a whole range of other decisions within the economy. The new identity that is noted implies that there are at least five tax gaps that have impact on this total:

1. The tax policy gap, which refers to the cost of potential tax bases not taxed by choice e.g. wealth, which is untaxed in many economies;
2. The tax spend gap, which refers to the costs (both positive and negative) of granting higher and lower rates of tax that vary from the norm or standard rate as well as the cost of all allowances and reliefs granted to taxpayers, for whatever reason;
3. The cost of tax evasion;
4. The cost of tax avoidance;
5. The cost of tax bad debt i.e. declared sums owing but not actually paid.

In this context I conclude:

MMT has had a substantial impact on much economic debate in recent years. Amongst its contributions has been the suggestion that there is not a 'tax and spend cycle,' but a 'spend and tax cycle'. This is liberating and allows for a re-conceptualisation of the role of tax within the economy. Rather than balancing a government's fiscal equation, with indifference as to how the cash sum that achieves this goal is raised, tax can an instrument of social, economic and fiscal (regulatory) policy. The idea that tax is a sum to be forecast when planning desired levels of inflation, as MMT considers necessary, is only possible if tax collected is seen as a residual of many other decisions implicit within that process. Various social and economic drivers of net tax owing require explicit consideration, as too do the various component elements of the tax gap. That consideration will extend to the requirement that all these sums be actively managed.

If the thinking implicit within modern monetary theory is to ever underpin the economic *strategy of a government, assessing the identified five tiers of tax gap, will be critical to its success in imposing control on the economy for which it has responsibility. Tax spillover analysis in both domestic and international arenas is also key to this process of designing tax systems that do not undermine themselves, while achieving social goals and simultaneously assisting control of aggregate demand. Any government embracing MMT will, then, need to adopt this methodology. Tax is key to the success or otherwise of modern monetary theory in practice. To date its importance has been underplayed and under appreciated. If modern monetary theory is to succeed therefore, it has to be paralleled by a more expansive form of modern taxation theory, as explained, aided by tools such as tax gap appraisal and tax spillover assessments.*

The paper elaborates these arguments, not all of which are even touched on here. But the point is critical. I have for a very long time suggested that MMT has not taken tax seriously and that this has been a major weakness within it. I was given the chance to explore this issue and have now done so. The aim is to contribute to debate. As I have noted, Randy Wray has already welcomed the piece in a mail to, suggesting it to be a significant advance in thinking.

Comments in that spirit are welcome.

Discussion of whether this should be called modern taxation theory are also welcome. I will be posting more on this issue over the next few days, I hope.

NB [The paper is available here]