Funding the Future

Tax After Coronavirus (TACs) : Tax and fiscal policy

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As was discussed in the introduction to this section on Tax and Society within the Tax After Coronavirus (TACs) project, tax has at least six roles to play in any society. Delivering what is called fiscal policy is one of those roles. This section explores that issue.

Reorganising the economy using fiscal policy

If all government spending was directly funded by tax in exact equal and opposite amount then the amount of tax collected within the economy would have little overall economic impact: the level of government spending would then be the primary fiscal tool available to government for managing economic activity within that jurisdiction. However, as a matter of fact government spending need not be wholly funded by tax, as previously noted. It can also be funded by borrowing and, as has also been previously noted, some governments can also fund their spending with new money created by a government (direct monetary funding) specifically for this purpose.

Colloquially this practice of direct monetary funding is often called 'printing money' but that is usually an inappropriate term. Whilst it is true that physical currency - literally, cash — is, of course, government created, and much of that currency is printed, as a matter of fact most of the money that governments create is electronic, just as most of the deposits in most of the bank accounts in most countries in the world are also now simply records of purely electronic transactions in which physical cash never played a part. The most common current form of cash creation that has been used by those governments most able to fund their activities in this way is now called quantitative easing.

It is, of course, also important to note that just as governments can borrow to fund their spending they can also tax to fund their loan repayments, or to cancel money that they have created and put into circulation in their economy.

The technical details of how government borrowing and quantitative easing (in particular) take place are not important to the Making Tax Work project. What is important is that it is understood that governments frequently have good reasons for deciding that they want to run deficits, which means that they spend more in cash terms than they collect in tax, whether they fund the resulting deficit by either borrowing or money creation. Likewise, they can also have good reason to run surpluses, which mean that they raise more in tax than they spend in cash, with the result that they reduce their borrowing or cancel some of the money that they have injected into the economy, for example by reversing quantitative easing.

It is important to understand what the reasons for these deliberate deficits and surpluses are. Either can be described by the generic term 'fiscal policy'. This term simply means that government deficits or surpluses are being used to influence the way that an economy is functioning. There are a number of reasons why a government might want to use fiscal policy.

Firstly, a government might use fiscal policy because the alternative to fiscal policy, which is called monetary policy, cannot work for it. Monetary policy is a term used to describe the deliberate setting of interest rates within an economy by a government at rates that might influence the level of economic activity. Higher interest rates within an economy tend to reduce the amount of borrowing in an economy, and so reduce the rate of growth and economy activity within it by restricting the availability of credit to fund growth. In contrast, lower interest rates tend to encourage borrowing, and that in turn tends to stimulate more economic activity, and so growth.

Governments were very keen on monetary policy from about 1980 onwards, but in the last decade in very many countries in the world interest rates that governments can influence have been very low, and that means the policy is now largely ineffective in many jurisdictions. There are also countries where monetary policy cannot work because the currency in use is that of another country. In these cases fiscal policy might be the only viable alternative for a government to use if it wants to have influence over the level of economic activity taking place in its jurisdiction.

In practice, fiscal policy is usually more complex than this issue of simply running surpluses or deficits. The term usually extends to what issues the government wishes to promote whilst simultaneously running those surpluses or deficits. So, for example, fiscal policy can be used in association with decisions about the tax system to encourage particular types of activity e.g. investment in new types of industry. Or, it can be used to subsidise some parts of the population e.g. those on low income. Alternatively, it may be decided to use tax policy to create social transformation, such as the delivery of environmental change. All of these policies can be linked to the decisions made about whether to run a surplus or deficit, or not.

Fiscal policy is, then, very often delivered in a way that is chosen to speed up the impact of a particular policy. As was previously noted, if there was, for example, a desire to encourage growth then directing the benefit of a government deficit towards those on low incomes is likely to have the greatest impact in achieving this goal in a short time period. Fiscal policy is, then, not just about choosing whether to run deficits or surpluses but is also about deciding how those deficits and surpluses might be created with the aim of helping to achieve a particularly desired outcome within a society.