Funding the Future

Tax After Coronavirus (TACs) : Tax, revenue, money and ...

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Tax After Coronavirus
Tax and society

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. Raising revenue is one of them, but the function that it plays when doing so is more complicated than most people imagine, and can vary depending on which government is undertaking that activity. This section explores these issues.

Whilst most people think that all governments need to raise revenue to pay for the services that they provide, it should be immediately apparent that this is not true in all cases. Many governments, whether of countries, subnational states or regions, local authorities, or otherwise, borrow to help fund some of their spending. This inevitably means that they are not completely dependent on tax to fund their activities.

Tax and borrowing

It is also important to note that whilst it is often claimed that tax revenues are required to ensure that any government can repay its loans this is not necessarily true. In practice the vast majority of governments, of whatever their type, that borrow never make much in the way of loan repayment: they do, instead, keep rolling their loans over by taking out new loans as old ones mature. So long as a government still has stable and secure tax revenues coming in that are sufficient to satisfy their creditors that they are able to make payment of the interest due on their loans few governments encounter many difficulties in doing this.

What this means is that most governments have some choice about the mix that they will use between tax and borrowed funds to finance their programmes, and understanding the relationship between these two sources of funding is critical if the tax system is, in itself, to be understood. Appreciating the relationship between government deficits and tax revenues is critical to understanding Tax After Coronavirus

(TACs).

Tax and money creation

In addition to loans it is also the case that some governments, at least in theory, have no theoretical dependency on tax at all. In the case of a government that issues its own currency and that has its own central-bank the normal logic of government financing that is commonly fixed in most people's minds is completely reversed. In these very particular circumstances, which are not enjoyed by all countries (including, for example, those in the eurozone, as well as those that are forced to borrow in foreign currencies, as well as in the case of almost all sub-national governments) a government does not, and even cannot, tax first and then spend, as most people presume to be the case, but must spend first and then tax.

There is a very particular reason for this: unless a government of this particular sort that is actually responsible for creating the money that is in use in its jurisdiction first actually spends its currency into the economy by, for example, buying goods and services from people and businesses within it, then those people and businesses would not have the currency that they would need to pay the tax that is owing in that same currency.

This is a real 'chicken and egg' conundrum. Whilst it is usually assumed that tax must come before spending, that can only be true if the currency in which those taxes are to be paid already exists. This will be the case for countries without their own currencies, and for almost all subnational governments of whatever form they might take, because they will use the currencies of the country in which they are located, but for governments which are responsible for the creation of a national currency then government spending must come before tax can be charged if payment of tax in that currency is to be required by.

This is the case because governments do not create money by simply giving it away. They do instead put it into circulation by spending it and getting value in exchange. In that case, then, government expenditure must, as a matter of fact, always come before taxation revenues can be raised if a government is seeking to make sure that its own currency is in use in the economy to which it is responsible.

In these particular situations governments are not, them theoretically dependent upon tax to deliver their programmes. They could, in principle, just create more money to pay for whatever they wanted. There is, however, a very obvious problem with doing so, which is that this would inevitably result in ever-increasing levels of inflation, as more and more money was pumped into the economy. This has, of course, been seen in some countries around the world. So, in the situation where a government has its own central bank and its own currency (but not otherwise) tax revenue is not raised to pay for government expenditure, as such, but to instead reclaim the money that the government has spent into the economy when buying goods and services from people within it using the money that it creates for that purpose at its own central bank. In effect, the tax raised does in these cases cancel the money that the government created to pay for the goods and services it has bought, and as a result the tax collected keeps the overall money supply available to the economy under control with the primary concern being the control of inflation. Tax revenue in these circumstances does, then, become a vital tool of economic management.

Tax budgeting and inflation

Critically, the books of a government that is in this situation of having its own currency do not need to be balanced: instead the objective of a government in this situation is to run whatever deficits or surpluses are necessary to control the level of inflation which is arising within that economy, taking into consideration any desired inflation rate that they might decide upon. So, for example, if they have a desired inflation rate of 2% and the actual rate is 4% per annum then they will want to slow down the rate of growth in the economy, and will as a result wish to run a government financial surplus, or in other words, collect more cash in tax than they actually spend in cash terms during the course of the period. This has the net effect of withdrawing money from the economy, so reducing the purchasing power of people within it. This will necessarily mean that there is less money available to buy goods and services within the economy, which will reduce the pressure on prices, and so bring inflation back under control.

In contrast, if there was insufficient inflation within an economy, and most economists think that some inflation is a good thing for an economy because it usually stimulates growth, then the government can run a deficit, meaning that it spends more in cash terms than it raises in taxation, and the resulting additional cash that is injected into the economy boosts available spending power within the economy, ensuring as a result that there is an increase in prices, which is what a government would want in this situation.

The importance of tax revenue

It is important to stress that this quite complicated explanation does not mean that governments do not need to raise revenue. As a matter of fact, every government that wants to control inflation will always want to raise tax revenues, but the reasons why a government may want to raise revenue will alter, and to understand this fact is important. Those governments that do not create their own currency, which when sub-national and local governments are taken into account is the vast majority of government in the world, do need to raise revenue to fund their expenditure, as popular imagination presumes to be the normal case. However, those countries that do have their own currencies do instead need to raise revenue to control inflation because they are in the very special situation of being money creators, and for them raising revenue through taxation is primarily a mechanism for ensuring that their money supply is under control as a mechanism for controlling inflation. This has particularly important implications when government taxation policies, budgets, deficits and other issues are being considered which is why this issue has to be understood.