The political economy of money

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The power to create money belongs to the state

A state is defined by its ability to:

- Define and defend its borders.
- Legislate within its domain.
- Create a currency.
- Tax.

All other aspects of political economy flow from these issues. In that case, and presuming that the definition and defence of borders is not an issue of concern, the power of the state to create a currency and to tax is fundamental to its ability to create and enforce policy that meets the needs of its population. A proper understanding of the relationship between these issues is, then, fundamental to the creation of successful policies.

Definitions

Some terms need to be defined:

- A currency is the unit of account used to describe the money in use in a jurisdiction.
- Money is a measure of debts owing denominated in the currency of a jurisdiction. Money may also be used as a measure of the value of debt-based exchanges that have taken place within an economy.
- A fiat-currency is the currency declared to be the legal tender of a jurisdiction by its government. This is a legal concept: a currency is legal tender merely because the government of a place declares it to be so using its power to legislate.
- An asset-backed currency is a fiat currency that enjoys the right of convertibility into another asset if a debt denominated in it defaults due to the action of the currency

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issuing state. The liability owing then becomes payable in gold or some other currency.

- Tax is a legal obligation contractually due to a state because economic events of a prescribed form have occurred.
- Government borrowing if denominated in the currency of the jurisdiction in which the borrowing takes place is a facility offered by the government of that place for the safe deposit of funds by those who wish to place them with a government owned and backed institution always guaranteed to be able to repay its debts. This is akin to a banking arrangement.
- Government borrowing denominated in the currency of a jurisdiction other than that which has borrowed represents a promise to pay requiring that the government that has borrowed secure access to sufficient of the currency in which the borrowing took place by the time that repayment is due. This is a debtor relationship.

Some technical issues also need to be addressed:

- Base money is money put into circulation by the central bank of a jurisdiction. Base money is denominated in the fiat currency of the issuing jurisdiction. That money is issued into circulation as a record of the promise to pay made by the government of the jurisdiction in question that it offers in exchange for the supply of goods and services procured by it.

  Examples of base money include notes and coins. It also includes the balances held by commercial banks with the central bank of a jurisdiction that represents sums spent into the economy of its jurisdiction by a government and not recovered by it from within that economy either by way of borrowing or taxation.

  Base money is destroyed by the payment of tax and the issue of government debt issued in the fiat currency of the jurisdiction.

  There is no theoretical limit to the amount of base currency that a jurisdiction may issue. However, to issue such currency in an attempt to procure resources in a jurisdiction already at full employment will always result in inflation unless additional tax charges are simultaneously imposed. As such there are practical constraints on the issue of base money.

- Commercial bank created money is money created by the commercial banks of a jurisdiction when advancing loans to a customer who promises to make repayment of that debt in return. Commercial bank money is destroyed by the repayment of the bank loan that created it. The practical limits to the capacity to create money in this form are:

  - The availability of borrower with the ability to make repayment.
  - The availability of capital within banks to sustain bad debts arising on debts that default.
  - Regulation intended to direct credit or to limit its availability.

- **The payment of tax has to always follow the expenditure of money by the government.** Given that governments with stable currencies always demand payment of tax in their own currency (so creating a demand for it within their economies) this has to be true: if the spend did not come first then there would be no money available to pay the tax due.

Consequences

If these definitions are accepted:

1. All money is debt: as matter of fact the nature of double entry book-keeping, which is the only verifiable method available to record monetary transactions, does not permit it to be otherwise.
2. Debt free money cannot exist as a result. Money on deposit is always owed to the depositor. Money owed to a bank or other person is always a debt. There is no money that exists that is not a liability of one person and the asset of another.
3. Money can only acquire value because of its capacity to settle a debt.
4. Base money acquires its value because it is used to settle tax liabilities owing, which are legally created debts intended to impart value to a currency.
5. Tax does not as a result fund government spending: it cancels the money created by government spending, whose legal creation is permitted by a properly authorised government budget.
6. All money is as a consequence intangible in its nature.
7. Money cannot be asset backed: it can however be guaranteed, but that is not the same thing. The best guarantor of money is the government because it alone has the capacity create money without limit within an economy, which it can do because it alone knows that if this were to happen the sums in question would be redeposited with banks, who thereafter would return them to the government via its central bank. This means that this guarantee never has to be drawn upon to be effective, which is why it can be and is widely used (e.g. to guarantee all deposits to £85,000 in UK bank accounts).

8. Tax, if not used to fund government spending acquires a range of other social purposes:
    a. To ratify the value of the currency: this means that by demanding payment of tax in the currency it has to be used for transactions in a jurisdiction;
    b. To reclaim the money the government has spent into the economy in fulfilment of its democratic mandate;
    c. To redistribute income and wealth;
    d. To reprice goods and services;
    e. To raise democratic representation - people who pay tax vote;
    f. To reorganise the economy i.e. fiscal policy.
9. Governments do not spend taxpayers' money. They do, instead, create new base money to fund their expenditure. That base money is then cancelled, largely through the imposition of taxation charges.
10. Banks to not lend depositors' funds to customers when advancing loans. They do, instead, always create new money when doing so based upon the mutual promises to pay that the bank and the customer exchange when arranging that loan. Money created in this way is cancelled by repayment of the loan.
11. Governments do not borrow money in their own currency to fund government expenditure. Governments do, instead, provide a safe deposit facility for their own currency whether created by their own spending or by commercial bank lending. This is a banking arrangement. The funds in question might properly be thought of as part of the national capital of jurisdiction. If hypothecated for investment purposes, this might explicitly be the case.
12. Commercial banks do not require deposits to make loans to customers. Deposited funds are never loaned in this way. Depositors' funds are, instead, part of the capital of the bank, and are available to meet its obligations to all creditors in the event of default by some or all of its customers.

Economic policy

Based upon this understanding a government should in pursuit of a sustainable economic policy:

1. Must determine the sustainable capacity of its economy, taking into consideration labour, natural, financial and manufactured capital resources.
2. Determine the potential value in use of those resources.
3. Decide on what part of those resources it might wish to procure to supply public services, and what value those services might have.

4. Determine the quantum of its resulting expenditure, also taking into consideration any desire it might have to maintain, replenish or deplete capital stocks, and taking into consideration the multiplier effects of its own spending, if material.
5. Decide the extent to which the remaining net injection of funds into the economy that it might make needs to be withdrawn from circulation by way of taxation as a necessary means of controlling inflation if that is a perceived risk.
6. Determine the extent, if any, to which commercial credit creation needs to be controlled to facilitate the government's economic objectives and to consider the resulting necessary regulatory and taxation changes required to achieve this outcome.
7. Determine the extent to which it might wish to change the sums it has borrowed, considering interest rate policy as a part of this process.
8. Determine which taxes at what rates might fulfil its social, economic and environmental goals.
9. Determine which policies might minimise the impact of interest charges and other rent seeking activity within the economy as a whole in pursuit of its social policies.
10. Make clear its intentions and the reason for them.
11. Communicate these issues, including to banks and others directly impacted as a result.
12. Adequately resource those agencies such as HM Revenue & Customs that are critical to delivery of these goals.

Conclusions

Most currently commonplace thinking, such as that which suggests that tax funds government expenditure, and that deposited funds are loaned by banks to their customers, is wrong.

The latter has been explicitly recognised to be wrong by the Bank of England and other central banks.

The former is implicitly recognised within the operation of central bank reserve accounts, which have become commonplace and material within most developed economies since the 2008 global financial crisis.

Ben Bernanke summarised this very effectively when discussing how the money to pay for the 2008 Global Financial Crisis was found. He said[2]:

[2] Quoted at https://www.ft.com/content/5e5b2afb-c689-4faf-9b47-92c74fc07e66

> "It's not tax[payers'] money. The banks have accounts with the Fed, much the same way that you have an account in a commercial bank. So to lend to a bank, we simply use the computer to mark up the size of the account that they have at the Fed."

And that is how the government pays for everything. It is also how most money is created. And it is why tax is essential to cancel the impact. Everything else is a footnote.