Funding the Future

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There was a fundamental flaw in the first line of the Executive Summary of HM Revenue & Customs' Transformation Roadmap, published, like many other government documents, just before the summer recess begins, yesterday. It said

HM Revenue and Customs (HMRC) has a vital purpose – collecting the money that funds public services.

The trouble is that this claim is entirely untrue. HMRC does not fund any government services. And since the government does not understand what HMRC does, or what the purpose of tax is, it's unsurprising that the rest of the report was lame, technocratic, and almost certainly undeliverable because I very much doubt that most people have the ability to make the tax system work for them online via apps, which is essentially what the plan says will happen.

In that case, bear with me as I address, for the umpteenth time, this false claim that tax funds the government and why it is wrong.

The reality is that the UK government (like other currency-issuing governments) creates money every time it spends. Tax does not fund spending; instead, tax is the necessary consequence of government spending and is required to prevent inflation resulting from excessive money supply. Tax comes after government spending, in other words.

The steps involved are as follows:

1. Government creates money when it spends

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The UK government instructs the Bank of England to make payments on its behalf.

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When the Bank of England credits bank accounts, new money is created in the economy.

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This process has been in place since at least 1866, when the Bank agreed to always

honour government spending if approved by Parliament.

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Government spending is therefore not financed by taxes or borrowing, but by instructing its own central bank to create money.

2. Tax comes second—not first

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Tax is not collected and then spent.

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Instead, the government spends first, which adds money into the economy.

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Tax is then used to remove some of that money from the economy to manage inflation and regulate demand.

* The tax paid funds nothing. It simply cancels a tax debt, and then ceases to exist.

3. The purpose of tax is not to raise funds, but to serve economic and social functions

Tax serves several key purposes in the economy:

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It controls inflation by removing excess money from the economy.

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It can reduce inequality by redistributing wealth.

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It can influence behaviour through incentives or penalties (e.g., carbon, alcohol, and tobacco taxes).

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It can support democracy, by creating a link between citizens and government.

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It does give value to money, since people must pay taxes in the government’s currency and so they use it in everyday transactions.

4. Borrowing also does not fund spending

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When the government issues bonds, it is not because it needs the money.

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It is offering a safe savings vehicle and a tool to manage interest rates.

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The government does not borrow to spend. It borrows after it has spent, primarily to drain excess reserves from the banking system. The funds deposited were created by government spending in the first place.

* Borrowing exists to provide:
* Stability to the banking, pension and insurance sectors.
* Macroeconomic control of interest rates.
* A place for foreign reserves to be held in sterling.

5. Misunderstanding this leads to harmful policies

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Thinking that tax funds spending leads to austerity, underinvestment, and fearmongering about deficits.

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It gives rise to false analogies between households and governments (“balancing the books”) when the fundamental constraint on government spending is a lack of real resources to spend on, creating the risk of inflation if that spending is attempted in that case, and not deficits or debt.

Conclusion:

Since all government spending is inherently financed by money creation, the role of tax is not to fund public services. Instead, tax serves regulatory, redistributive, and stabilising functions in the economy. Recognising this would revolutionise how we approach public investment, debt, and social priorities.

It would also mean that the government could provide proper direction to HMRC's management on their tasks. Instead, yesterday indicated that they have no clue as to what the economic role of tax is, and so HMRC is being misdirected. Of course, what follows on from a misdirection of such giant proportions is bound to be wrong.