Funding the Future

Taxation

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This is the sixth in a series of essays on the politics of care and economics of hope. The others are listed at the end of this essay.

As with the other essays, I acknowledge the input of my wife, Jacqueline, into this essay, although less than usual in this case.

In previous essays in this series, I have set out how money actually works.

A government that issues its own currency creates the money it spends, rather than drawing on funds it must first collect. That is not a controversial technical claim. It follows from how currency is issued and how public accounts actually operate.

Once that is understood, a second question follows immediately. If government does not need our money before it can spend, why does it tax us at all?

The conventional answer is that government taxes us, and then spends what it has raised. That answer feels obvious, but it is also wrong, and the mistake matters more than it might seem.

What taxation is not for

Taxation does not fund government spending in the way that a person's income funds their spending. It cannot, because government must first put money into the economy through spending before any of us have the money with which to pay our taxes. The sequence runs the opposite way to the one most people assume.

That is not a technicality. It changes what taxation is for.

If taxation is not there to fund government, then every argument that treats tax rises and spending increases as two sides of the same ledger is starting from the wrong premise.

So is every argument that treats a tax cut as something that must be paid for by cuts elsewhere.

Those arguments only work if you believe government is a household, dependent on income before it can spend.

A currency-issuing government is not a household. It does not save up. It authorises, and then it spends.

That does not mean taxation is pointless. It means we have been asking the wrong question about it. The question is not how do we raise enough money. The question is what taxation is actually for.

Why we tax anyway

If money is not the constraint, then taxation must be doing something else. In fact, it is doing several things at once, and a benign government has to understand all of them if it is to use taxation well.

The first purpose of taxation is to withdraw spending power from the economy.

Government spending puts money into circulation. If nothing removed some of it again, there would be more money chasing claims on the goods, services and resources the economy can actually produce, and prices would rise. Taxation reclaims money to keep total demand in balance with what the economy can supply. It is a tool for managing inflation, not a precondition for spending.

That single change of understanding removes much of the fear that surrounds public spending. The limit on what a government can do is not the size of its tax take. The limit is the real resources, the people, skills, materials and capacity, available in the economy at any moment. Tax is one of the tools used to keep spending within that limit. It is not the source of the money being spent.

The second purpose of taxation is to redistribute income and wealth.

Markets do not produce fair outcomes left to themselves. They produce outcomes shaped by inherited advantage, market power and luck, as much as by effort or contribution. A society that wants everyone to have the chance to realise their potential cannot leave the distribution of income and wealth entirely to market forces. Taxation, applied progressively, is one of the principal means by which a democratic society corrects that distribution after the market has had its say.

This is not an argument for taxing for its own sake. It is an argument that a benign government has a duty to ask, continually, whether the pattern of income and wealth that markets produce is one that a caring society should accept, and to use taxation as one of the tools available when the answer is no.

The third purpose of taxation is to change behaviour.

Prices carry signals. When something is underpriced relative to the harm it causes, whether to health, to community or to the environment, people will consume more of it than is good for them or for anyone else. Taxation can correct that mispricing. It can make the honest cost of a harmful activity visible in what it costs to do it. Used this way, tax is not a punishment. It is a correction to a price that was already wrong before the tax was applied.

The fourth purpose of taxation is to sustain democratic accountability.

There is a real difference between a government that must ask its citizens for tax and explain what it is for, and a government that could in principle ignore its citizens altogether because it does not need anything from them. The requirement to raise tax, publicly and by law, forces government into a continuing conversation with the people who pay it. That conversation is not an incidental benefit of taxation. It is part of what taxation is there to protect. A government that taxes visibly and explains itself is a government kept answerable in a way that one which simply issued money into a vacuum would not be.

The fifth purpose of taxation is to give the currency its value.

A currency has value because the government that issues it requires it to be used to settle a real and unavoidable obligation, the tax owed to that government. That obligation is what creates the demand for the currency in the first place. Take away the tax obligation, and you take away the principal reason anyone needs the government's money at all. Taxation does not just manage an economy that already runs on a trusted currency. It is one of the things that makes the currency worth trusting.

The sixth purpose of taxation is to act as a deliberate tool of economic management.

This is distinct from the first purpose. Withdrawing spending power to keep demand in line with what the economy can supply is a constant, background function of taxation. Fiscal policy is something more active than that. It is the decision to raise or lower taxation, or to change spending, in order to steer the economy through a particular moment to cool an economy that is overheating or support one that is faltering.

Taxation and spending together are the two instruments of fiscal policy, and neither makes sense without the other. A benign government does not simply set tax rates once and leave them. It adjusts them, deliberately and transparently, as the state of the economy requires, in the same way it adjusts spending, because both are levers on the same machine. It seems that few tax commentators appreciate this.

What follows from this

None of these six reasons for tax makes it a lesser concern because it does not fund government spending. Instead, they make it a more precise one.

If taxation exists to manage inflation, redistribute income and wealth, correct mispriced harms, sustain democratic accountability, underpin the value of the currency, and serve as an active instrument of economic management, then every decision about who to tax, what to tax and how much to tax should be judged against those six purposes, not against the fiction that tax revenue must first exist before spending can happen.

That reframing changes the questions worth asking about any tax policy. The question is not, how much will this raise? Instead, it is, does this correctly manage demand, does it make the distribution of income and wealth fairer, does it price harm honestly, does it strengthen the connection between government and the people it serves, does it protect confidence in the currency itself, and does it move the economy in the direction it currently needs to move? These are what tax policy should be about.

A benign government does not tax because it has run out of money. It taxes because a fair, stable and accountable society requires it to. Understanding that is not a technical adjustment to how we think about tax. It is the beginning of a different relationship between government, money and the people both are meant to serve.

There is, inevitably, a further question this raises. If money is not the constraint on what government can do, and taxation is not there to fund what it does, then the question of what government is for, and how it should be organised so that it uses these tools well, becomes unavoidable. That is the issue I will consider next.

Other essays in this series

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