THE MONETARY ROLE OF TAXES IN THE NATIONAL ECONOMY*

by

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ABSTRACT

All significant policy differences in macroeconomics have as origin competing conceptions of money. In this paper, we seek to explore how taxes are conceived within a monetary circuit framework that focuses on the flux/reflux mechanism fundamental to the understanding of a modern monetary economy in which credit plays an essential role. Starting from an analysis of the canonical version of the circuit, the state is then introduced within our analytical framework. This is subsequently followed by a discussion of the various fiscal policy issues that can be addressed using this competing approach. As a rule, our analysis stands on its head the traditional policy prescriptions that are based on the erroneous assumption that taxes finance government expenditures.

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1. Introduction: Two Different Conceptions of Money

Even the layman’s view of taxes suggests that they are intimately linked with money. The more taxes one pays, the less money one will have left to spend. This implies that any analysis of taxes must necessarily address their relation with money. Attempting to dissociate the two will simply hamper our understanding of how modern monetary economies actually work. Therefore, in order to understand the role of taxes we must first understand the meaning and role of money. As it turns out, money has been and still is at the centre of policy debate. As discussed elsewhere (Seccareccia, 1993), it was Keynes who most clearly pointed out that what is fundamentally at the origin of the great policy divide in macroeconomics is economists’ own competing conceptions of money. A review of the literature indicates that there are two main conceptions of money, which are diametrically opposed.

Most mainstream neoclassical economists view money as a commodity whose intrinsic worth, its utility, is guaranteed by its relative scarcity and whose role, in merely greasing the wheels of trade, ensures its long-run neutrality. Neoclassical economists going back to Menger (1892) have argued that historically, precious metals emerged "spontaneously" (i.e., without the intervention of the state) as acceptable media of exchange because of their
intrinsic characteristics of fungibility, divisibility, durability and portability. "Money", Menger (1892: 255) wrote, "has not been generated by law. In its origin it is a social [i.e., market], and not a state-institution. ... [state recognition and state regulation] have not first made money of the precious metals, but have only perfected them in their function as money." Moreover, given the monetary commodity’s supply constraint, banks play no role in monetary creation since they are conceived solely as intermediaries in their capacity to transfer a scarce monetary resource from savers to investors. Commercial bank deposits, and even central bank notes, appear, therefore, simply as "surrogates" for commodity money (Realfonzo, 1998, chapter 2). It is only when this money supply constraint is lifted, because of the reckless actions of the state authorities (or of commercial banks) to acquire seigniorage revenues, that instabilities in prices and output arise.

In opposition to such textbook orthodoxy, most heterodox conceptions of money reject this Mengerian commodity view which, to all intents and purposes, describes nothing more than a generalized barter system with a numéraire money appended to it. Based on a tradition whose origin goes still further back to ancient times (see Seccareccia, 1999), most heterodox economists view money as a token or symbol with only an extrinsic worth and whose supply is endogenous to the social and physical reproductive needs of a community. Hence, what essentially is behind money is the state both as the ultimate purveyor of liquidity and as the legal authority that bestows on the token its status as legal tender money within an institutional structure defined by the state (see Innes, 1913). Rejecting the scarcity principle that remains at the heart of the commodity conception of money, it is the economics of abundance which now applies.

This competing conception of money, generically referred to as the Chartalist approach, views money as a creature of the state and, moreover, highlights the historical link between the existence and creation of money and the fiscal needs of the political authorities (Wray, 1998; Mosler and Forstater, 1999; and, among many others, Bell, 2001). Indeed, just to quote Lerner (1947) who had followed from Knapp (1924):

"The modern state can make anything it chooses generally acceptable as money and thus establish its value quite apart from any connection, even of the most formal kind, with gold or backing of any kind. It is true that a simple declaration that such and such money will not do, even if backed by the most convincing constitutional evidence of the state’s absolute sovereignty. But if the state is willing to accept the proposed money in the payment of taxes and other obligations to itself the trick is done. [...] What this means is that whatever may have been the history of gold, at the present time, in a normally well-working economy, money is a creature of the state. Its general acceptability, which is its all-important attribute, stands or falls by its acceptability by the state." (Lerner, 1947: 313).

In more advanced monetary economies in which has evolved a system of banking institutions that create "inside" money \textit{ex nihilo} via bank credit advances denominated in the monetary unit defined by the state, both the legal existence of such institutions and the possible fulfilment of their liquidity needs (such as during times of crises) still would very much depend ultimately on the actions of the state (Parguez and Seccareccia, 2000).

Historically, classical and neoclassical economists generally subscribe to the commodity conception of money, while most of the critics of orthodoxy find themselves on the side of the competing endogenous money camp (\textit{cf.} Seccareccia, 1999). However, among others, one very obvious exception to this generalization is Marx, as well as Marxist writers, who have traditionally had their feet stuck firmly in both camps. For one thing, it is well known that, following the Ricardian tradition, Marx had largely theorized on the basis of commodity money --- a conception of money that still preoccupies many modern Marxist writers (see Fleetwood, 2000). On the other hand, as some have argued (see, \textit{inter alia}, Graziani, 1997), Marx himself had offered a powerful analysis of the monetary economy that necessarily broke away from the commodity conception of money.

In his famous formula of the circuit of money-capital, money follows a definite cycle starting with a sum of money ($M$) that is advanced to purchase commodity inputs and labour power ($C$) only to return as a greater sum of money for the capitalist ($M’$). When consolidating the various $M-C-M’$ cycles economy-wide, we can thus hypothesize an aggregate monetary circuit that follows a definite sequence. First there is a monetary advance by firms within the phase of production in which money emerges primarily to finance the purchase of labour power, thereby reflecting a specific power relation between capital and labour in their access to credit that is based on the significant collateral that the former can offer banks vis-à-vis the latter (Bellofiore and Realfonzo, 1997; Bellofiore and Seccareccia, 1999). This is then followed by a monetary reflux within the phase of circulation, in which money appears...
merely to facilitate exchange among producers and consumers in accordance with neoclassical precepts of money.

The question that now needs to be posed is whether the assumption of commodity money is compatible with this general Marxian analysis of the monetary circuit. As pointed out by Graziani (1997: 31), unlike the circulation phase in which the use of commodity money can be envisaged, in the production phase of the Marxian circuit, money cannot possibly be conceived as a commodity but purely as credit money. Graziani (1997) writes:

"The capitalist acquires labor power for the purpose of producing commodities; if money were itself a commodity, the process would seem to be turned upside down and the capitalist would employ a commodity for the purpose of acquiring labor power. Moreover, if money were a commodity, it would have to be the result of a prior productive process, which would in turn need money to be realized. If, therefore, money is to be construed as a commodity, one would have to assume, as an initial premise of the argument, the existence of a commodity that had the characteristics of money, without, however, being able to explain where it came from." [Emphasis in original] (Graziani, 1997: 31)

Faced with the problem of infinite regress, it would ensue that ab ovo the initial advances (M) must be in the nature of credit money and cannot be commodity money, say, in the form of precious metals. Indeed, as pointed out by Bellofiore and Realfonzo (1997: 100) since, in a capitalist economy, the money wage bill is advanced logically prior to the production of commodities and therefore logically prior to the production of the commodity money itself, money cannot ab initio be a commodity. Hence, as Keynes was later to emphasize, a monetary production economy precludes the existence of commodity money, and the latter can only be relevant to the understanding of a Mengerian pure exchange economy that abstracts from Marx’s production cycle.

Given the irrelevance of the neoclassical conception of money to the understanding of modern monetary production economies, in the following section we shall first analyze the nature of the monetary circuit as it provides a more realistic explanation of the relations among banks, firms and households and then introduce the state within this general circuitist framework. This approach allows us to explain, in section 3, the role of taxes in the dynamics of a modern monetary economy and at the same time to shed light on the appropriate macroeconomic policies that ought to be put in place for economic stabilization. Some concluding remarks are offered in the last section.

2. The Theory of the Monetary Circuit

As it has been discussed elsewhere (see Parguez and Seccareccia, 2000), the central proposition of the theory of monetary circuit is that, in a modern capitalist economy, money is the result of a balance sheet operation in which buyers and sellers engage in economic transactions by means of a liability issued by a third agent, whether it be a central bank or a commercial bank. Every transaction is thus simultaneously a balance sheet process which either creates or destroys money. This debt issued by the third agent, the bank, is by its very nature endogenous and has no prior existence since it only appears at the moment that a transaction takes place and it is destroyed when the debt towards the third agent is extinguished. This bank liability is demanded in an economy and commands purchasing power on the basis of the existing and future wealth created by those who were granted the credit money and who now need liquidity to extinguish their previously-incurred debts vis-à-vis commercial banks (both principal and interest) and/or the state (i.e., in the form of taxes). Ultimately, however, the general acceptability of this third-agent debt depends on the legal apparatus of the state in endorsing the bank liability along Chartalist lines.

To grasp the implications of this for the understanding of the role of taxes within the national economy, let us begin, for simplicity, with the canonical version of the theory of the monetary circuit as found, among others, in Graziani (1990, 1994). We suppose a closed system in which there are only three groups of economic agents: households (who supply their labour and may hold financial assets), firms (which, as a group, engage in production by hiring labourers via bank borrowing), and banks (who supply credit requirements based on the creditworthiness of the borrowing firms). For the purpose of the analysis, we shall first abstract from the direct role of the state, and we shall assume a closed economy. Although the first of these restrictive assumptions will be done away with shortly, we shall first focus on the core credit-debt relations that permeate a private capitalist economy and then introduce the role of the state.
Since both production and exchange take time, the framework of the monetary circuit is a temporal one that entails sequential analysis. Abstracting from certain minor complications discussed elsewhere as to what exactly needs to be financed (Seccareccia, 1996; 1998), at the starting phase of the production cycle, business enterprises require short-term (or initial) finance that will allow them to purchase the necessary working capital needed to undertake production which, for the consolidated business sector, can be reduced to the payment of wages. This is quickly followed by a second phase in which the employed labour undertakes production on the basis of an agreed-upon money wage and produces either consumption goods (to be sold to households) or capital goods (for inter-firm purchases). These two starting phases are part of the monetary "efflux" process associated with the initial finance. During this "efflux" process, firms therefore build up their stock of short-term debt with the banking system and workers begin producing goods that are not yet available in the commodities market. Regardless of whether overall output in such an economy is following a stationary or growth path from period to period, production must initially entail the accumulation of short-term debt.

However, once production is completed and firms begin to sell their products during the circulation phase, the "reflux" process of the monetary circuit begins, thus allowing firms to reimburse their previously-incurred short-term debts with the banks. Depending on their propensity to save, households spend a certain portion of their income (Y) to purchase the consumption goods that they have produced. The remaining portion is saved. In the classical case in which workers’ propensity to save is zero (s=0), all that was initially advanced as outstanding bank credit is returned to firms in the form of sales proceeds and firms can now wipe out their short-term debt via the cash reflux. However, if the propensity to save is greater than zero (s>0), firms will have to issue securities (B) in the financial capital market, and hopefully capture the total of the flow of household savings (S_h) withheld from the commodities market, in order to extinguish their short-term debt with the banks. This is what Graziani (1990) terms "final finance", which is associated with the reflux mechanism of the monetary circuit. This "final" finance is generally compatible with the more traditional vocabulary of "internal" finance when firms are able to capture a portion of the previously-created credit money by selling products directly to consumers and thereby generating a net cash flow from which are derived firms’ retained earnings (or business savings), and "external" finance where business enterprises must also float longer-term securities in the financial markets in order to refinance their short-term bank debt (because s>0).

Yet, there is one case in which the closure of the monetary circuit is not possible because of the Keynesian problem of household liquidity preference. In the case where households choose to hold part of their savings in the form of bank deposits, banks would now be forced into a sort of perverse financial "intermediation" role of re-issuing short-term loans to firms caused by the existence of liquid household deposits withdrawn from the reflux process. Needless to say, this Keynesian problem of insufficient reflux from the private sector to ensure the closure of the monetary circuit would easily disappear if some other sector, particularly the government sector, would incur deficits, by providing the additional liquidity to offset the leakage because of strong household preference for liquidity (see Bougrine, 2000).

**Figure 1: Monetary Flows Among Banks, Firms and Households**

\[ iM + Y_h \]

\[ M Y_w \]
This core scheme of the monetary circuit is depicted in Figure 1 illustrating the three major sectors of the private economy: banks, firms and households. $M$ represents the initial advances of credit money equivalent, in this case, to household income ($Y$) at the beginning of the period of the circuit. In turn, $Y$ is either spent on consumption goods ($C$) or disposed of as savings ($S_h$) channelled towards the financial markets to purchase new long-term securities ($B$) issued by business enterprises to meet their financial obligations to the banks at the end of the period of the circuit. The reflux to the banks, equal to the principal of the loans, $M$, plus interest, $rM$, would appear at first glance to the reader as a pure macroeconomic Ponzi system, since unless firms also borrow the interest $rM$, they would never be able to pay back the principal plus interest. In reality, however, banks are not only advancing $M$ to firms but (as shown by the separate arrow flowing directly to households) a sum equal to $(1 + i)M + Y_b$, where $i$ is the interest on deposits and $Y_b$ is the flow of non-interest payments made to households whose income depends on the banking sector (which, in Figure 1, is shown separately from the income $Y_w$ accruing to income earners in the non-financial business sector).

Although various scenarios are possible (which have been discussed in Seccareccia, 1996), it is clear, that abstracting momentarily from household liquidity preference ($\Phi$), the circuit would come to a closure when the reflux $[(1 + r)M = (1 + r) Y = C + B]$ is equal to the efflux $[(1 + i)M + Y_b]$. From this, it can easily be seen, among other things, that any variation in the interest rate spread ($r - i$), indicating bank profit margin, would make the closure of the circuit more or less difficult. Moreover, as indicated above, household liquidity preference represented by $\Phi$ in Figure 1 would be an additional leakage from the system, thereby creating a further Keynesian obstacle to the closure of the monetary circuit. However, while much of what we have delineated here is familiar to heterodox economists trained in the Keynesian tradition, what we have described can also be conceived macroeconomically as a more coherent and natural extension of the familiar $M-C-M'$ circuit of money-capital to be found in Marxist writings discussed previously.

Despite its appeal in correctly describing the nature and role of credit money in a monetary production economy, there is one very obvious problem with the above analysis. The state sector is not explicitly addressed. In a sense, it is already implicitly there because it is the state that establishes the legal/institutional framework for the working of the credit-money system and because the private banking system would still need the state as the ultimate purveyor of liquidity if commercial banks become "short-circuited" during times of financial crises. However, given the importance of the state sector, this circuitist framework can and, indeed, must be extended to the public sector (as Parguez (2000) argues forcefully). In this case, the monetary relations become somewhat more complex because one has to take into account the existence of two additional institutions: the central bank (which can be considered the banking side of the state in its role in both financing government outlays and in targeting short-term interest rates) and the Treasury (which...
carries out the fiscal operations of the state, i.e., in its role of carrying out government spending and taxation). Both sides of the state are critically important (i) in affecting overall levels of income because of the direct impact of the Treasury activities on private sector disposable income via public spending and taxation and (ii) in influencing private sector spending decisions, through the central bank’s leadership role in setting interest rates by its control of the overnight rate.

**Figure 2: Flows of Funds: Central Bank, Treasury and Private Sector**

| Purchase of government securities, Advances & Redeposits |
| Government spending |

Tax receipts

Sale of government securities, Reimbursements & Drawdowns

As displayed in Figure 2, these two activities of the state impact on the private economy but largely through the effect they have on commercial banks. This is because fiscal operations of the state modify directly the amount of high-powered money in the economic system, which in turn affects the reserve position of commercial banks. However, analogous to the relations described in Figure 1 above, just like business enterprises during the "efflux" phase, the state spends money that must be financed by its banking department: the central bank. Indeed, in the same way as firms were unable to "finance" their initial spending by future revenues that do not yet exist and, therefore, must rely on bank credit, the same would apply to the state. In both cases when firms and the state engage in spending, there must be money creation.

Consequently, the state cannot finance its spending by means of tax revenues and/or the selling of bonds since these pertain to the reflux phase of the monetary circuit. All central government expenditures must be financed through the central bank unless the latter does not exist or it is prevented from doing so (as in the case of the European Monetary Union), in which case the state’s spending is financed via commercial bank advances (see Parguez and Seccareccia, 2000).

### 3. The Role of Taxes in the National Economy

The institutional framework in many modern economies supports the circuit theory outlined above. For instance, in addition to income, consumption and property taxes, the Canadian System of National Accounts considers as taxes all receipts from "fiscal monopolies (liquor and gaming profits), business licences, motor vehicle licences and all local government licences and permits". Although health insurance premiums and contributions to social insurance plans used be considered as a tax category prior to the 1997 Historical Revision of the Canadian System of National Accounts, they are now considered as non-tax revenues and are added to taxes and receipts from sales of the government’s goods and services as well as its investment income in order to get the government’s ‘total revenue’ (Statistics Canada, 2000: 54-55).

From an accounting perspective, this is a clear indication that all components on the revenue side represent flows of funds from the private sector to the government’s account at the Central Bank as shown in Figure 2. At any point in time, these flows reduce the amount of money available in the economy. Similarly, all disbursements represent flows of funds from the government’s account to the private sector and would obviously increase the amount of money (see Table 1 below). Consequently, in order to maintain an appropriate amount of liquidity in the system, the government, via its banker, must
ensure that there is a certain degree of coordination between its overall receipts and its disbursements. To do so requires that the Central Bank "neutralize certain public sector flows that affect the financial system. These include all receipts and disbursements of the federal government as well as the Bank of Canada’s own transactions and those of its clients" (Bank of Canada, 1999: 9).

If there are any discrepancies between receipts and disbursements and if, for instance, "the government were to receive $100 million net in taxes into its account at the Bank of Canada (the government’s banker), in the absence of any neutralization action, settlement balances in the system would decline by this amount." Therefore, unless "The Bank would [...] arrange a net increase of $100 million in the government deposits auction" this decline in settlement balances will lead to competition for funds and put upward pressure on the overnight interest rate (Howard, 1998: 60). This implies that if the Central Bank wants to succeed in its role of keeping the "target rate" within the operating band, it must intervene constantly and neutralize with some accuracy "the net impact of any public sector flows between the Bank of Canada’s balance sheet and that of the financial system" (Howard, 1998: 59). However, this accuracy is not achieved easily since in practice the inflows and outflows of funds are not perfectly synchronized. In fact, as Bell (1998) points out when studying the financing operations of the Treasury at the U.S. Federal Reserve:

"It is impossible to perfectly balance (in timing and amount) the government’s receipts with its expenditures. The best the Treasury and the Fed can do is to compare estimates of anticipated changes in the Treasury’s account at the Fed and transfer approximately the correct amount to/from T & L [Tax and Loan] accounts. Errors due to excessive or insufficient T & L "calls" are the norm." [Emphasis in original] (Bell, 1998: 23).

Therefore, even if it wanted to coordinate its "efflux" with the "reflux", de facto the Treasury would not be able to do so on a day-to-day basis.

The transactions that add to or reduce the amount of money are conveniently summarized in Table 1 below (see also Clinton, 1991). These transactions reflect the flow of funds between the government (or its central bank) and the rest of the economy. Therefore, there is no doubt that the Bank of Canada agrees that taxes (as well as the rest of the items on the left-hand side of Table 1) serve to reduce the amount of money available to the private sector. While this recognition by the Bank of Canada may seem a simple matter of accounting logic, it actually has very important implications and goes one step towards a better understanding of the meaning of money and the role of taxes in modern economies.

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<thead>
<tr>
<th>Items that reduce the amount of money</th>
<th>Items that add to the amount of money</th>
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<tr>
<td>1. Taxes and other receipts</td>
<td>1. Regular disbursements of the federal government</td>
</tr>
<tr>
<td>2. Official sales of foreign exchange</td>
<td>2. Official purchases of foreign exchange</td>
</tr>
<tr>
<td>3. Decrease in Receiver General deposits with direct clearers (drawdowns of the government’s account with chartered banks and financial institutions)</td>
<td>3. Increase in Receiver General deposits with direct clearers (redeposits in the government’s account with chartered banks and financial institutions)</td>
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<tr>
<td>5. Increase in Sale and Repurchase Agreements of government of Canada securities</td>
<td>5. Increase in Purchase and Resale Agreements of government of Canada securities</td>
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At first glance, Table 1 looks like a standard account with debits and credits and may give the impression that the government uses its receipts (the credit side) to pay for its disbursements (the debit side). However, a close examination of the items on each side of the Table reveals a different story. To see this, we must recognize that at the beginning of the fiscal year when the budget is decided and the government starts making actual disbursements, taxes are not yet collected. Moreover, taxes cannot be collected at the beginning of the period because incomes on which they are levied have not yet been earned. Therefore, if taxes are to be considered as government’s income in any sense at all, then it must be said that they are an income which is contingent on the realization of private agents’ income and therefore can only be determined \textit{ex post}. The question that should be asked then is how can we claim that an \textit{ex-post} income is used to finance an \textit{ex-ante} economic activity? This is clearly not possible. In a sense, in accordance with Chartalist theory, money must first be spent before it can be collected in taxes.

Since taxes can only be collected \textit{ex post}, the requirement that the government finance its expenditures by taxes means that the entire public sector would come to a halt and no public goods or services could be made available. In order for government operations to proceed and incomes to be earned in the public sector, all that is required is that the banking arm of government accepts to honour the cheques issued by its fiscal arm, the Treasury. Since these cheques will then be deposited by the public within the commercial banking system, the government's account at the central bank will be debited whereas private agents’ accounts at commercial banks will be credited by the same amount. Only at this stage, when private sector incomes are directly being earned from the government spending, as well as indirectly because of its stimulative impact on private sector spending and indebtedness via the usual multiplier/accelerator effects, would the state start to collect taxes and other contributions. It is, furthermore, during this phase that money is now being destroyed and the Treasury’s ‘debt’ towards the central bank is extinguished \textit{pari passu} with the tax reflux.

To draw the parallel with the efflux/reflux phases described earlier for the firms sector, we must therefore note that government expenditures are associated with the initial financing (efflux) while taxes are logically distinct and are concerned with the reflux side (or the final financing) --- that is to say, they are the outcome of previous expenditures by firms, households and the state. In that regard, the whole notion of "financing the deficit" is somewhat of a misnomer. The budget deficit, which is the accounting difference between the initial spending and current-period tax revenues, can only be considered an \textit{ex post} accounting identity that has already been financed. However, unlike firms, as highlighted by Parguez and Seccareccia (2000: 111), as long as a central bank exists and is legally permitted to finance government expenditures, the state can \textit{plan} the amount of its future expenditures relative to anticipated tax revenues, since it would not be subject to the creditworthiness criteria that commercial banks would normally apply to firms.

The logic of the monetary circuit when applied to the state sector suggests, therefore, that there is a clear link between the fiscal and monetary arms of the state. During the efflux phase, the central bank must continually be crediting the Treasury while at the same time conducting open-market operations of selling government securities in order to eliminate the excess reserves that would be otherwise accumulating within the banking system. Hence, within the logic of Figure 2 above, since government expenditures are already financed and the state is not confronted with any effective creditworthiness rules, the operation of buying/selling securities from/to the public cannot, strictly speaking, be a final financing operation in the same way as private firms would need to do so in financial markets when faced with insufficient cash revenues to extinguish their short-term bank debts. The operation of buying/selling government securities in the open market would have as object the targeting of short-term interest rates by the central bank, that is, by managing commercial bank reserves so as not to jeopardize the central bank’s control of the overnight rate.

To clarify the point further, let us assume that government expenditures are continually outpacing government revenues as was the case during the late 1970s and the 1980s in Canada, in which case \textit{ceteris paribus} the central bank would be accumulating a growing share of public debt. The central bank would, however, quickly be forced to divest itself of the additional government securities, not because of the unfounded fears of inflation that this ‘debt monetization’ would supposedly generate (\textit{cf.} Seccareccia and Sood, 2000), but because of the effect that growing excess reserves by banks would have
on the overnight rate. Hence, unless it was simultaneously following a policy of raising required reserves (indeed the opposite had actually been instituted in Canada with their eventual disappearance in 1994), the central bank would be forced to sell government securities in order to prevent the overnight rate and other related short-term interest rates from falling to zero (see Mosler 1997-98). Hence, instead of government budget deficits putting upward pressure on interest rates either because of ‘crowding-out’ effects on the basis of Hayekian loanable funds theory or because of their presumed inflationary consequences due to the traditional Fisher effect, budget deficits would actually bring about falling short-term interest rates, unless the central bank intervenes to prevent them from declining. In much the same way, if the government were running a budget surplus and thereby reducing the public debt, as has been the case in more recent years in Canada, the opposite would arise. Since in this case ‘tax revenues’ are greater than current expenditures, banks would be chronically drained of reserves, which would create undesired upward pressures on the overnight rate.

However, as government bonds progressively reach maturity and the government pays off the public debt, this would increase overall reserves and therefore largely offset the negative pressures that the growing budget surplus would have on bank reserves. It is only because of any lack of synchronization between the time when tax receipts flow to the Treasury and government bonds are coming to maturity that the central bank may be forced to engage in open market operations or effectuate operations of redeposits and drawdowns in order to maintain the target overnight rate. It ensues, therefore, that the two branches of the state must be engaged somewhat in a balancing act in order for the central bank to maintain its control over short-term interest rates.

3.1 Taxes and Fiscal Policy

As can be inferred from the above discussion, a correct understanding of the notion of taxes is critically important because all economic policies are based on the premise that taxes pay for government spending. Indeed, this premise is central to all policy proposals advocated by orthodox economists. For instance, the proponents of ‘sound finance’ argue that taxes are the primary and principal source of government finance and that borrowing and ‘printing money’ must be avoided. Toye (2000), for instance, attributes the existence of the welfare state and its social programmes in developed countries to their success in "establishing the institutions necessary for the direct taxation of the majority of adult population during the first half of the twentieth century." Referring to the situation in developing countries, he notes that "The absence of direct personal taxation on the revenue side of the budget is matched by the absence, on the expenditure side, of much spending on social security, education and health services." (Toye, 2000: 36)

It is clear that the basic premise in neo-conservative budgeting is that decisions made by fiscal authorities as collective agents must obey the same rules as decisions made by individual agents. Governments are cautioned against spending more than their ‘tax revenues’. Balancing the budget, however, means that governments must accept austerity as their guiding principle and therefore abandon economic policies seeking to achieve, among other goals, full employment and social justice. The conclusion then, which often comes in the form of policy recommendation to both developing and developed countries is that, since there are strong economic and political reasons that justify the constraints on the use of debt and money creation as well as the limits of the use of increased taxation ‘to raise additional government revenue’, the ‘interventionist strategy’ of economic growth is untenable and must be abandoned. This view is based on a serious and dangerous misunderstanding of public finance and the role of money in modern economies. The following discussion clarifies why.

As mentioned above, taxes are considered the source of government revenue and therefore necessary for financing public sector activity. According to this view, a large public sector would require higher taxes. In turn, high taxes are assumed to lower the net return on private investment and thus discourage risky investment projects. High taxes are also said to discourage individuals from supplying adequate work-time. For these reasons, high taxes are considered bad for economic growth. Consequently, proponents of this view call for a smaller public sector, which means less government involvement in economic activity and a greater role for the private sector (i.e., privatization of public corporations and social services such as health care, education, etc.).
There are several problems with this view and at least as many reasons why it hinders economic growth. First, it must be noted that taxes are not required at all for financing government spending as we have just shown. Abba Lerner (1943) had already tackled this issue long ago when he commented that:

"taxing is never to be undertaken merely because the government needs to make money payments. Taxation should therefore be imposed only when it is desirable that the taxpayers shall have less money to spend, for example, when they would otherwise spend enough to bring about inflation". (Lerner, 1943: 40)

At the macroeconomic level, the primary function of taxes, therefore, is not to finance government spending but rather to regulate the economy by preventing inflation (when private spending might be too high) and unemployment (when it is too low).

Secondly, since taxes are considered the only legitimate source of government revenue and since they are supposed to be kept as low as possible in accordance with the view defended by Lindbeck et al. (1993) among others, policy makers refrain from engaging in any type of public spending, including on social programmes and infrastructure projects. This situation is prevalent in many developing countries where it often derives from policy directives of international institutions such as the World Bank and the IMF (see for instance, IMF, 1995). From the point of view of governments in these countries, the justification is indeed very simple: they cannot afford such projects because there is no money to pay for them. This attitude clearly hinders economic growth and maintains millions of people in poverty, not because taxes are low but because government spending is arbitrarily tied to taxes and therefore arbitrarily kept low.

Thirdly, when it is necessary to maintain the provision of basic public services (such as health and education) at a certain minimum or when it becomes necessary to invest in infrastructure (either to expand or improve it), policy makers, believing that taxes are an important source of government revenue, resort to levying higher taxes. Again, this type of fiscal policy hinders economic growth not because higher taxes might discourage risky private investment but because higher taxes withdraw a larger proportion of private sector income and therefore reduce total spending by the same amount unless the government puts back into the economy what it would have collected in taxes. However, even in the case where the government balances its budget by equating its expenditures with taxes one can see that this policy stance does not favour economic growth since there is no active role on the part of the state to lift the constraint or the upper limit on total spending, which is the source of economic expansion.

When responsible governments resist cutting public expenditures and balancing their budgets at all costs, the objection and warning they get from orthodox economists are both scary and misleading. Toye (2000: 33-34), for instance, writes:

"Some governments, when faced by an unsustainable fiscal deficit and a total of public expenditures that should not be further reduced, turn to other forms of public finance than raising tax revenues. They try to borrow their way out of the problem, and to print money. [...] The very limited scope for financing government expenditure by domestic borrowing and by printing money has long been appreciated.[...] Only reckless, desperate or oppressive governments venture beyond the limits, which are relatively easily calculated, of these forms of finance."

In defending this position, Toye explains that governments in the first place resort to borrowing and printing money because the tax base is too small to generate sufficient funds. Since he assumes that interest on the public debt must be paid out of taxation, he concludes that unless the tax base is broadened, the growing debt will not be sustainable and the confidence of lenders will be undermined, therefore limiting the government’s borrowing capability.

Concerning the second financing option, Toye (2000) puts forth two arguments, which are all too familiar by now. The first is that ‘printing money’ is inflationary and the higher incidence of inflation tax reduces the real value of the government’s seigniorage and, according to Toye, forces private economic agents out of the formal and into the informal sector, therefore eroding the tax base so that in the end the government is unlikely to add its resources by resorting to printing money. The second argument against ‘printing money’ is that liberalisation of financial and foreign exchange markets reduces the demand for domestic money since the private sector now has the possibility to exchange it for other assets, which reduces the government’s
ability to raise additional funds through inflation tax.

3. 2 Can Taxes Redistribute Wealth?

Having discussed the macroeconomic nature of taxes in the national economy, one may now legitimately analyze their redistributive consequences on private sector income and wealth. As Parguez (2000) correctly points out, at the macroeconomic level, state spending can redistribute incomes and wealth in favour of specific groups in society, but taxes cannot redistribute them from one group (say, the rich) in favour of some other group (the poor). For instance, it should now be obvious to the reader that taxes cannot fund, say, social programmes that support the poor for the very simple reason that taxes are not part of the efflux but, rather, an element of the reflux within the monetary system. Taxes, therefore, are there to destroy money; their role is not to fund public spending. Taxes can in no way be an instrument to redistribute income from high-income groups to low-income groups. Indeed, it could actually be argued that, for a given level of public spending, higher taxes destroy the ability of the economy to produce future output and wealth, not because of the disincentive effects on work, etc., traditionally emphasized by neoclassical supply-side economists, but because of their macroeconomic consequence of withdrawing money from which private and social wealth are generated.

For this reason, when one sees policy makers on the political Left fighting against tax cuts because supposedly taxes are needed to ‘fund’ social programmes, we would argue that their fight is somewhat misdirected. Hence, when, for example, those who draw up the Alternative Federal Budget in Canada begin with the premise of a balancing budget, and then seek to juggle federal revenues with federal expenditures, they have already swallowed the traditional vocabulary and put themselves in a neoclassical straitjacket that presumes that tax revenues ‘fund’ government expenditures. Indeed, it is quite ironic that, with few exceptions (see Papadimitriou and Wray, 2001), so many on the political Left in the U.S. are actually fighting tax cuts of the Bush administration in the name of sound finance. In our opinion, the problem is not tax cuts but the policies of balanced budgets and fiscal surpluses pursued by both the previous Clinton and now the Bush administrations in the U.S., by the Liberal government in Canada, as well as by many social democratic governments in Europe, which have and will continue to destroy social programmes at the basis of the earlier post-war welfare state.

Where the critics of tax reductions have it right is when tax cuts are coupled with policies of budget balances or budget surpluses. That is to say, the problem is not tax cuts per se but whether the reduction in taxes becomes a sort of Trojan horse ultimately to bring down the share of public spending in the national economy, and thereby reduce the public sector’s contribution to the creation of wealth. While this has been the effective strategy of the political Right, the critics of such a policy should not place themselves in the rhetorical trap of defending policies of sound finance. Within the macroeconomic framework of the monetary circuit that we have presented, higher taxes reduce public indebtedness while greater deficits increase it and at the same time generate greater social wealth that we collectively share.

However, although taxes cannot transfer money from the more wealthy in order to finance income and expenditures of the poor, at the microeconomic level, they have important redistributive effects across households. By decreasing disposable income, a progressive tax structure does restrain households’ consumption expenditures and reduce their ability to accumulate private wealth. In this regard, taxes have an obvious redistribute effect by contributing to create a society in which both private consumption and private wealth accumulation would be more equitably distributed. Such tax structure could also favour, among other things, a consumption pattern that is less destructive to the environment. In this context, opponents of tax cuts are undoubtedly correct in pointing to the regressive nature of tax reductions being implemented by right-wing governments and in arguing that their incidence will increase the disposable income of the more wealthy.

4. Conclusion

Economic theory is plagued with a serious misunderstanding of the role, nature and meaning of money and taxes. The belief that taxes are a source of government revenue and that they can finance social programmes is a fallacy that has dominated economic reasoning in academic and policy circles for a long time. As a consequence, it is widely accepted that, as a rule, government spending must be constrained by the ‘limited financial resources’ it is able to raise out of taxation. Our analysis has shown that, contrary to common belief, taxes are part of a reflux phase in the monetary circuit and that, as such,
they are destroying money, not creating it. It follows that logically taxes cannot pay for public sector spending. Understanding the role of taxes within this circuitist framework is essential because it effectively liberates the government from being subject to an artificial, self-imposed budget constraint and, therefore, allows it actively to intervene and fill the gap of under-utilised capacity of society as a whole, i.e., strive to achieve full employment. Therefore, objections to tax cuts can only be justified if the government is at the same time pursuing a balanced budget policy, i.e., reducing its spending in order to balance the books, and if these cuts are not part of a progressive tax structure.

Bibliography


