IMPLICATIONS OF GOVERNMENTS WORLDWIDE EXCLUSIVELY RELYING ON THE CENTRAL BANK FOR THEIR EXPENDITURE, AS OPPOSED TO GENERATING REVENUE THROUGH TAXATION ON CITIZENS

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ABSTRACT

This research paper aims at analysing theways in which the central bank regulates the amount of money that is in circulation and the role of taxation in an economy.The paper also highlights the implications that would arise if Governments across the globe relied solely on newly created money by the central bank instead of taxing its citizens. Through past examples, the paper draws the advantages and disadvantages of this system.

Introduction

Role of Central Bank in controlling money supply

Central bank is a public institution whose main responsibility lies in implementing monetary policy, managing the currency of a country, or group of countries, and controlling the money supply.

- **Defining monetary policy** – One of the crucial tasks that the central bank needs to perform is to ensure price stability and economic growth. In order to achieve this,, financial authorities have tools like setting official interest rates, which have an impact on the cost of money. Keeping the current economic situation as the basis, central banks will either increase official interest rates or decrease them. One example when the central bank would increase official interest rates is to keep inflation under check. It may decrease the interest rates with a goal to encourage consumption and boost economic growth.

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Volume:08, Issue:10 "October 2023"

- **Regulating money in circulation** – central banks are the authority for issuing notes and coins, the money supply, and for regulating how much money is in circulation. This is done to inject liquidity into the economy so that different economic agents (families, companies and States) can use it in their transactions. Central banks are also responsible for carrying out operations to ensure that exchange rates of currencies remain stable, as well for owning and controlling their official reserves.

- **Overseeing the inter-bank market** – Central bank has to ensure that the relevant financial laws are respected and they monitor national payment systems to make sure that they are working properly.

- **Loaning liquidity to commercial banks if necessary for solvency issues** – Commercial banks can also receive liquidity from central banks in exchange for collateral, such as guaranteed public bonds. Thus, commercial banking institutions can cover what they need in the short-term, while the central banks try and ensure price stability by mediating in credit fluctuations[i].

Taxes

These are the imposition of compulsory levies on individuals or entities which serve as vital sources of income for the government. Taxes are levied in almost every country of the world, primarily to raise revenue for government expenditures, although they serve other purposes as well.ii Taxation may be described as the process by which democratic governments make their citizens bear the cost of public expenditure in unison with their ability to pay. It is a necessary instrument for promoting economic and social welfare; however, governments should use it judiciously to avoid stifling incentives, distorting economic behavior, and hindering growth.

Role of Taxes in an Economy

Irrespective of the status of a nation, developed or developing; Economic growth remains a macroeconomic objective. One of the main responsibilities of governments is to provide some basic infrastructure for the citizens. Other major responsibilities of a government include ensuring a stable economy, redistribution of income and provision of economic services.

The ability of the government to fulfil these responsibilities largely depends on the amount of revenue generated by them through both, internal and external sources available. Taxation is one such source. It is also one of the oldest means by which the expenses of the government is funded. Taxation also serves as a significant instrument for boosting the potential of public sector performance and repayment of public debt. A nation's pursuit of self-reliance and in meeting its economic regulation needs is largely fulfilled by taxation.

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Volume:08, Issue:10 "October 2023"

- Taxation is a mechanism through which the government seeks to realize some of its economic objectives.

- Taxation can be used to influence or direct the consumption pattern of citizens.

- It can be used to encourage or discourage investment in certain sectors of the economy. The government can significantly reduce the number of 'harmful', 'antisocial' but not illegal economic activities.

- It can also be used to protect local and small businesses and reposition them to better compete with their bigger, foreign counterparts.

- Taxation is a major source of government revenue and tax proceeds are used by the government to render their traditional functions such as: provision of good roads, maintenance of law and order, defense against external aggression, regulation of trade and business to ensure social and economic maintenance. Provision of these social services and infrastructure goes a long way to reduce the total cost of operation of a business. It means that businesses can expand their operations rather than striving to provide these services and infrastructures for themselves.

- Taxation and tax incentives like pioneer status, tax holidays among others can attract foreign investors to a country. This gives investors the opportunity to fully recoup their investments during such periods as well as reinvest such in order to operate on a larger scale. This brings about economies of scale. Again, capital allowances provide businesses the opportunity to recover the amounts they spend in capital expenditure. All these will eventually result in an expanded economy and thus economic growth.

However, taxation can also hinder economic growth by being inimical to economic activities. This is seen mostly in the form of high taxation, multiple taxation and double taxation.

- High taxation is when the government imposes too much tax on the profits of businesses or income of individuals.

- Multiple taxation is when several taxes are charged on the same income.

- Double taxation is when the same income is taxed more than once as it is moved from one geographical area (country) to another.

All these result in reduction in investible funds available to the taxpayer. Again, when taxes are evaded by taxpayers, the government may not be able to provide the necessary services it should.

ISSN: 2455-8834

Volume:08, Issue:10 "October 2023"

Thus, businesses will spend more in financing their operations than they would have spent normally. It is usually easier to provide for the cost of social infrastructure and services through a tax revenue pool than when businesses are to provide such for themselves individually.

Summarily, the role taxation has to play in an economy cannot be overstressed. However, this can only be attained when the nation crafts and implements a tax policy which is designed to mitigate the identified difficulties in her tax system. Efficiency and effectiveness of the tax system as well as accountability of revenue agencies and the government are all critical if taxation is to contribute to economic growth. Generally, taxes should be few, broad-based and high-revenue yielding. They should also be flexible enough so that changes in economic situations can easily be incorporated into the tax system.[iii]

While modern economics classifies taxes as the most important source of governmental revenue, some relatively new and controversial economic theories, like the Modern Monetary Theory (MMT), support the government's reliance on newly created money by the central bank. The theory challenges conventional beliefs about how the government interacts with the economy, the nature of money, and the use of taxes. This macroeconomic theory argues that revenues for government spending do not constrain countries that control their currencies.[iv]But beneath the surface of this monetary dance, a profound question lingers: What truly drives the government to make such economic decisions? Do rules and regulations blind policymakers, or is there a deeper, more intricate web of motivations that underpins their economic decisions? Through this paper, we will explore the advantages and disadvantages of a scenario in which a government, instead of funding its expenditure by taxing its population, relies solely on money newly created by the central bank.

Advantages of governments using newly created money by the central bank

A significant advantage of using newly created money is the immediate availability and injection of funds into the economy. While taxation is a time-consuming process, the agility provided by this method is particularly beneficial as it can facilitate rapid responses to economic crises or downturns. Instead of relying solely on tax revenues, governments can inject newly created money into the economy through the central bank through direct cash transfers to individuals, businesses, infrastructure projects, or increased government spending on various programs. Further, the injection of newly created money also acts as an economic stimulus, facilitating governments to boost aggregate demand and stimulate spending. This leads to economic growth fueled by job creation and increased production. The immediate benefit of this system can be seen during recessions when traditional fiscal measures may not be sufficient or may take longer to implement. Moreover, relying on newly created money can enable governments to finance essential public investments and infrastructure projects. Governments can embark on

ISSN: 2455-8834

Volume:08, Issue:10 "October 2023"

transformative initiatives to improve public services and drive long-term economic development, address critical infrastructure gaps, and promote societal progress without delays. Additionally, governments can fund social programs such as healthcare, education, and welfare using newly created money by the central bank. Such an approach allows governments to expand social services without imposing additional tax burdens on the citizens. Using the process of "monetizing the debt," the central bank purchases government bonds to finance governmental spending, thereby increasing the total money supply. The central bank can buy these bonds directly if there is limited demand for these bonds or concerns about raising interest rates. [v]Another benefit of this system is the reduction of administrative costs. Most governments make their money through taxation, whether at a local, state, or federal level. Implementing and managing taxation systems can be costly not only for governments but also for taxpayers. The reliance on newly created money enables governments to reduce administrative burdens associated with tax collection, enforcement, and compliance. It helps establish tax havens-countries with a jurisdiction that imposes little or no income tax and provides a stable political and economic environment.[vi]

John Maynard Keynes was a prominent British economist who argued for using fiscal and monetary policies to manage the economy. He wrote a book, "The General Theory of Employment, Interest and Money," advocating for government intervention through deficit spending and using newly created money to stimulate aggregate demand and overcome economic downturns. When critics argued that Keynesian support of public financing and deficit spending would lead to default in the long run, Keynes' famous retort was, "In the long run, we are all dead." He believed that governments should solve problems in the short run rather than wait for market forces to correct problems over the long run. [vii]

Disadvantages of governments relying on money created by the central bank

A primary concern with government-issued money is the potential for inflationary pressures. If the money supply is too rapid, there can be a loss in the currency's purchasing power, which can erode savings, disrupt price stability and decrease investment. Moreover, overreliance on newly created money could lower public confidence and trust in the currency. Citizens may become apprehensive about the ability of the government to manage the economy effectively, which leads to reduced trust in financial institutions, posing long-term negative consequences on investment, trade, and overall economic stability. Distorted resource allocation is another negative consequence of government-issued money, as it can lead to the misallocation of resources. The injection of newly created money directly into the economy, as opposed to funds through taxation or borrowing, will result in unsustainable economic bubbles, resource over-utilization, and inefficient allocation of labor and capital. Another very significant disadvantage of this system is undermining the central bank's independence as the governments rely heavily

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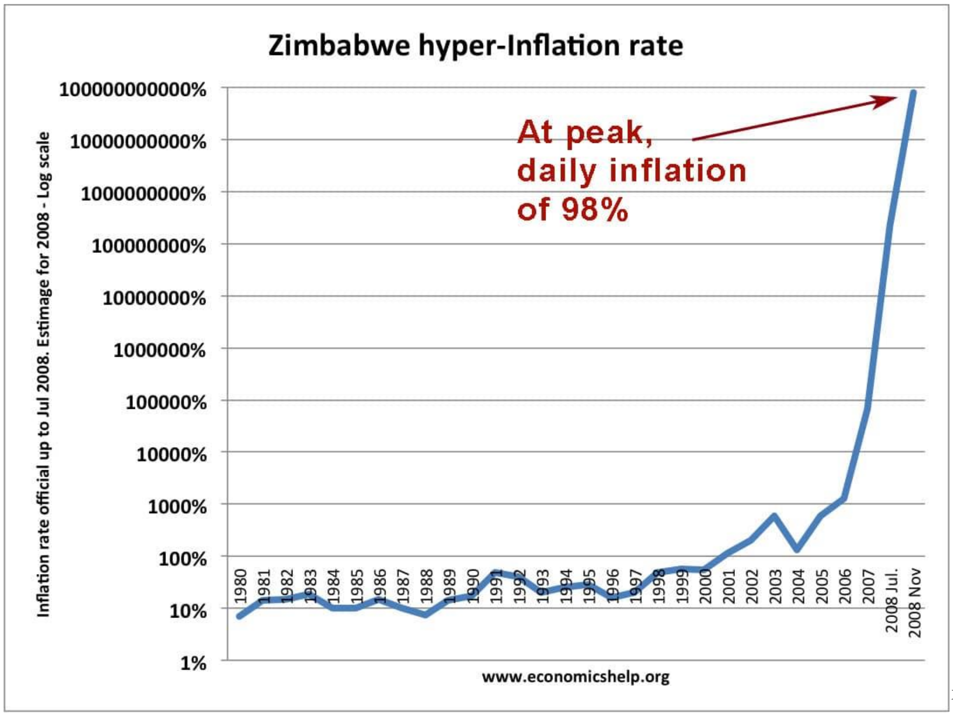
Volume:08, Issue:10 "October 2023"

on them to issue new money. This over-reliance can lead to political pressures on the central bank to create money, diminishing their ability to pursue sound monetary policies. Further, overreliance on newly created money would impact fiscal sustainability. Underlying fiscal challenges can be masked through money creation, as it avoids the immediate need for tax revenue or borrowing from the market. This practice can eventually lead to long-term debt accumulation as the central bank's balance sheet expands. Thus, it is imperative to be cognizant of the consequences of monetizing the debt and the potential burden it places on future generations. Furthermore, it is crucial to realize that taxes significantly contribute to redistributing wealth and reducing income inequality. When a government resorts to relying on newly created money by the central bank and eliminating taxes, it would lead to widening the wealth gap, exacerbating social tensions.

Through the annals of history, we can unveil profound insights and acquire timeless wisdom, illuminating our present and guiding our future with invaluable lessons. Some such lessons have been bestowed upon us by countries who practiced "deficit monetization" or "direct monetary financing" in which they relied on newly created money by the central bank, often referred to as "printing money" or engaging in "monetary financing," to fund government expenditure. [viii]

Example 1

The government of Zimbabwe faced severe fiscal imbalances and resorted to printing money to finance its expenditure. The rapid increase in money supply outpaced the production of goods and services, resulting in a loss of confidence in the currency. In 2008, Zimbabwe had the second-highest incidence of hyperinflation on record. The estimated inflation rate for Nov 2008 was 79,600,000,000%. [ix]



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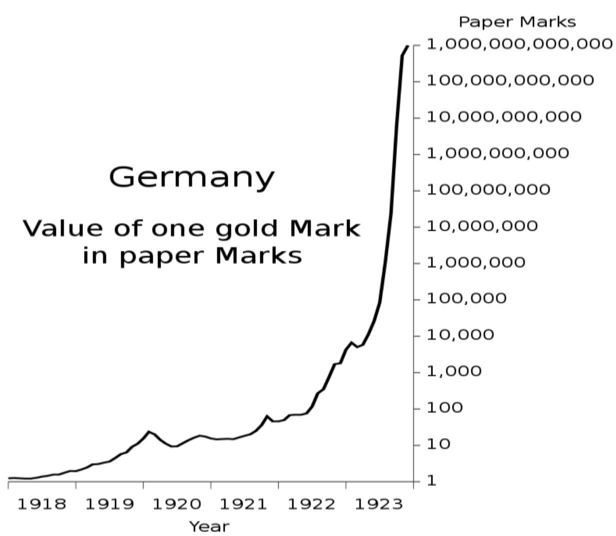
Example 2

Another notable example is the Weimar Republic (Germany), which in the aftermath of World War I, faced a heavy debt burden and resorted to money creation to meet its financial obligations, which eventually led to hyperinflation in the early 1920s, resulting in Germany becoming virtually worthless, thereby impoverishing millions of German citizens. [xi]



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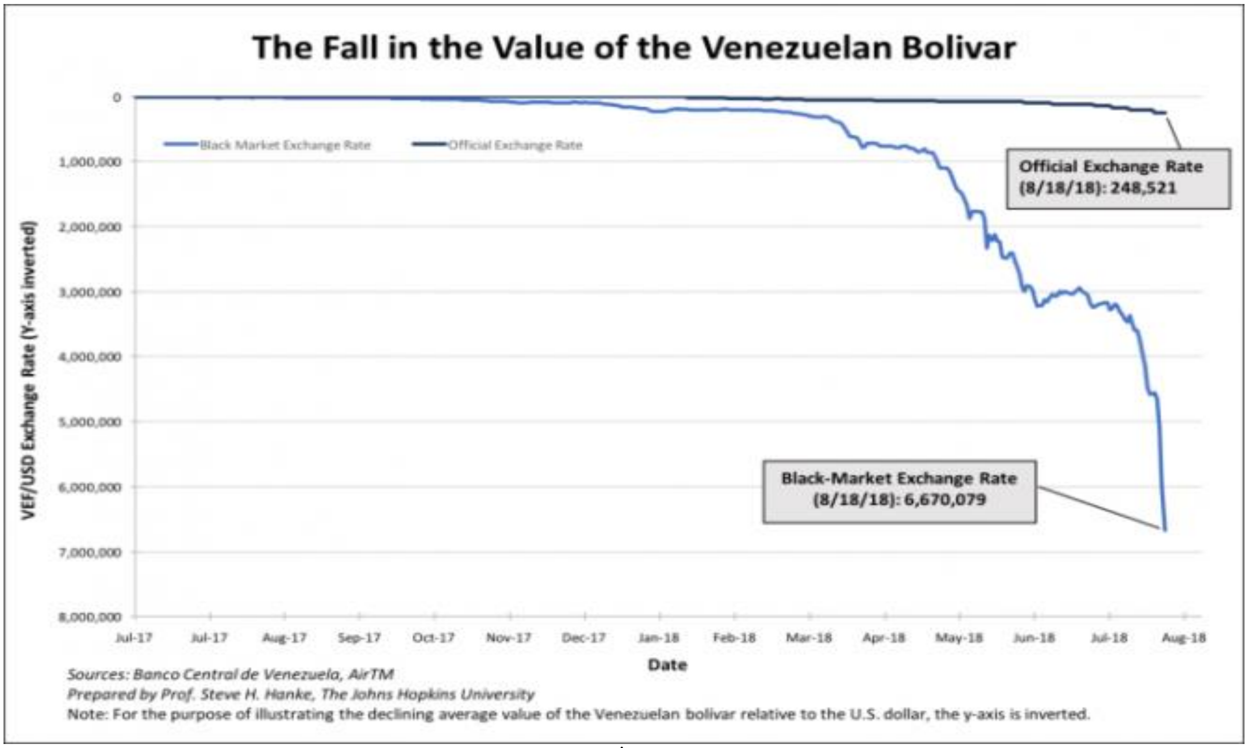
ISSN: 2455-8834

Volume:08, Issue:10 "October 2023"

Example 3

Venezuela too, in recent years, has faced severe hyperinflation, economic contraction, significant devaluation, and eventual worthlessness of the Venezuelan bolivar, as the government has heavily relied on money creation by the central bank to finance its budget deficits, social programs, and subsidies. [xiii]



[xiv]

While the cited examples portray the ill effects of governments relying on newly created money by the central bank, it is essential to be cognizant of the pre-existing assortment of additional problems in all these cases, such as government corruption or instability, a history of defaults on government debt, and an inability to borrow in the country's own currency. [xv]

Conclusion

The central bank's power to create money out of thin air is both a blessing and a curse. Used wisely, it can stimulate economic growth and stability. However, if mismanaged, it can lead to inflationary pressure and undermine trust in the currency. In contrast, the Modern Monetary Theory argues that governments should be able to spend newly created money by the central bank as they deem necessary without worrying about paying for it with higher taxes or increased borrowing, the pretext being a reduction in unemployment, promotion of green energy, better

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Volume:08, Issue:10 "October 2023"

healthcare and education. According to this view, the only drawback is that if inflation begins to rise, the only solution would be to increase taxes.

The dichotomy between central bank money and taxpayers' money thus presents us with a trade-off- while on the one hand, central bank money increases flexibility and standardized exchange; it raises deep concerns regarding inflation and democratic participation. On the other hand, money paid by citizens in the form of taxes is rooted in the principle of collective responsibility, which provides a mechanism for citizens to contribute to financial decisions and exercise oversight. However, it tends to lack the efficiency and flexibility exhibited by central bank money. The key is to strike the right balance between both approaches by carefully considering economic conditions, fiscal prudence, and broader economic and societal implications.

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