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Discussion On Government without Taxes

Notes for May 7, 2008 *Hardfire* show on a proposal to fund government without taxes and through issuing debt only

Proposal:

The proposal is that government could be funded strictly through the issuance of debt and without taxes, and that this would be a net savings to the taxpayer. In addition it is proposed that the need for the government to go back to the market for additional debt issuances would put pressure on government policy makers to re-justify programs and to gain voter approval for these programs. Lastly it is proposed that a government funded without taxes would be a net financial gain for citizens as the debt would be assets held as wealth by the citizenry.

Specifics of plan and critiques:

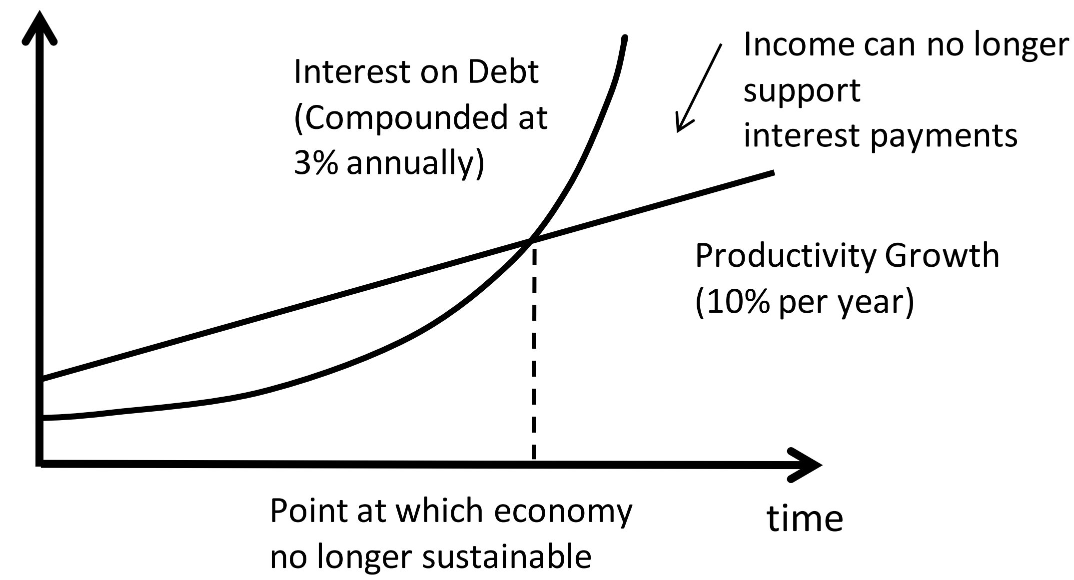
1) Only those government programs which ‘cash flow’ (have a positive Net Present Value, or, in other words, take in more money than they cost, adjusted for the interest rate on money) would be provided by the government, therefore government debt could be paid off by the income from government programs.

Critique: The “public goods” argument for government spending is based on the government providing goods which can’t be priced in the market because the goods or services are not tradeable and provide a public benefit from which people cannot be excluded. The main examples of public goods are national defense, police and fire protection, education and the court systems. These services help the community at large, but cannot be priced because they need to be on-going services and are only used when needed. Therefore some economists believe that the government should provide these services to the public. The only way that these programs would 'cash flow' is if the government were to charge for these services, this does not seem politically feasible (in some countries the 'loser pays' in lawsuits, however like all public goods this is hard to predict and therefore cannot be planned and priced). In addition, how would you price national defense? Any goods or services that the government provides that do cash flow can be privatized (this is already occurring for many highway projects viz. toll roads). Therefore, by definition, government programs do not cash flow with enough certainty against which to pledge income for the issuance of bonds. Any government programs that do cash flow should be privatized because they can be priced in the market.

2) Government financed by debt-only would be a net savings to taxpayers and the economy because the debt issued by the government would be assets held by citizens earning interest. This interest would stay in the country and add to the wealth of the country.

Critique: It is true that in a closed economy that a government without taxes may generate net savings as opposed to an economy in which the government raises taxes as well as issues debt. But this is only true if the government is a very small percentage of the economy, say 5%. However this is not the case in any developed country, where the average size of the government is 30% of the economy. In a developed modern economy, even if government could be reduced to 20%, the income needed to make payments on the interest of the debt would quickly be overcome by the compounded interest. In a very conservative case, assuming that productivity grows at 10% a year and the interest on the debt compounds at 3% annually there would come a time when the increase in interest payments would outgrow the productivity of the country. This is shown below.

Unsustainability of economy with a government funded by debt only



Income growth is dependent upon productivity growth. When the economy is no longer growing as quickly as the interest payments on the debt, the country would have to borrow from foreigners in order to fund its government. Without the benefit of taxes there would not be any investors willing to lend the government money because there would be uncertainty if the government could make the payments on the debt. This only means that the government would then have to increase the rate of interest to attract lenders. This then increases the compounding of the interest on the debt, making the point at which the country's economy is no longer sustainable arrive that much sooner.

Most importantly it is to be expected that the value of the currency of a country which funds its government through debt only would *depreciate in value*, due to the unsustainability of the economy (interest on government debt compounds exponentially and productivitry grows only linearly). The purchasing power of the people within in the country would depreciate in a world economy as the value of the currency goes down relative to other currencies. This means that the people in the country would face *inflation* as it would take more of their currency to buy the same things. In a global economy where all other countries fund their governments through taxes this means that the purchasing power of the currency, and the living standards of the people, can only be expected to go down relative to others in the world economy.

In addition, we do not live in a closed economy, the world's financial markets are globally integrated. This means that by definition some, or all, of the debt could be held by foreigners. In this case the government bonds would not be held as wealth of the people in the country but by foreigners as well. The wealth of the bonds cannot be guaranteeed to be held within the country. Therefore, as the domestic productivity is outstripped by the interest payments, and as foreigners become less willing to hold the country's debt, the people of the country become poorer and poorer. This is, obviously, not the intent of the proposal to fund government without taxes. The only way this idea could work is if the government was a very small percentage of the economy. This does not seem politically feasible for any existing modern country. For a developing country this is even less feasible because the country does not have the economic competitiveness as is, let alone with a currency that is bound to depreciate. No one would invest in a business enterprise in a developing country with an unsustainable economy, no matter how small the economy.

A counter-argument to the above is that a tax-free regime would allow for more greater productivity growth and would limit the government's ability to skew the tax code to special interests. This is very true. Productivity may indeed increase by several percentages. However, due to productivity being a linear growth, and interested being compounded exponentially, this would only mean that the point at which the economy is no longer sustainable will be farther out in the future. The fact that the economy is not sustainable in the long-run, and the fact that the currency will depreciate relative to other currencies (what is to prevent the government from just printing money to meet its debt obligations?) still requires that the interest rate on the debt be increased to attract investors. Productivity growth without taxes would not be great enough to prolong the inevitable indefenitely.

There are two addition points which should be mentioned. The first is what is known as Ricardian Equivalence, formalized by economist Robert Barro in 1974. This idea states that the people of a country rationalize any expected future interest payments on government debt and therefore save now to make the needed debt payments in the future. However, we know from experience in the United States, which has close to a negative savings rate and an increasing government debt, that this idea does not hold true. Secondly, there are *ethical* considerations beyond the econonic considerations. Do we really want to live in a society where we are bound to forever pass along debt to our children? I would say that, no, we do not.

Also it is should be noted that the wealthy are more able to buy financial assets than the poor, thus, a policy of debt-only funded government would be a *regressive* policy, whereas tax policy with increased tax rates on the wealthy is *progressive*.

3) Forcing the government to put debt issuance up to the voters would mean that political accountability over government would increase as the government would have to justify its programs at the time of every debt issuance.

Critique: As stated above, the only programs which are economically justifiable in strict economic terms are those programs which are not 'priceable' in the market, which are public goods. The demand for these goods and services are unknown and unknowable at any given time. Therefore it is not possible to know how much debt is needed at any given time. If the government programs are in place to provide these public goods in one period there is no way to justify any deviations, either increases or decreases, for the next period. Only government estimates (or private estimates, which would have to be based on government data) for future periods could be used to deviate from existing programs. This is not substantially different from government funded with taxes as well as debt.

Conclusion:

While interesting in principle (and who would not like to live in a society without taxes? Civil society and philanthropy might replace the dependency of the welfare state) the proposal is not economically sound due to the inflationary aspects of the proposed macroeconomic regime. A better solution would be to require government to have a balanced budget, this would also require government to scrutinize its programs and put limits on the growth of special interest programs.

We will end with a quote from John Maynard Keynes in *The Economic Consequences of the Peace* (1920).

> By a continuing process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens. By this method they not only confiscate, but they also confiscate arbitrarily; and, while the process impoverishes many, it actually enriches some….There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency. The process engages all the hidden forces of economic law on the side of destruction, and it does it in a manner which not one in a million is able to diagnose.