

Federal Taxes Do Not Finance Spending

Cost-Benefit Analysis Must Change

How much must the United States government spend to save life as we know it from climate catastrophe?

Answers vary: Representative Alexandria Ocasio-Cortez says at least \$10 trillion. The American Action Forum, led by the former Director of the Congressional Budget Office, estimates \$93 trillion. A seemingly significant number lies between these two estimates: \$20.67 trillion.

As of April 2023, there are only \$20.67 trillion of “M2” money—cash, bank accounts, mutual funds, and money market securities—in existence across the entire world. If the cost of saving the planet is above this number, then how will the federal government ever tax enough dollars to finance the changes required to fix climate change?

The answer is the government will not. In fact, an increasingly popular school of economics known as **Modern Monetary Theory (MMT)** argues that federal taxes never finance spending. This theory of currency, also known as Chartalism, is not new. It has been around in the United States since the country began leaving the gold standard in 1933 to adopt a “fiat” currency in its place. Beardsley Ruml, then the chair of the New York Federal Reserve, gave a speech in 1945 to the American Bar Association titled, “*Federal Taxes for Revenue are Obsolete.*” But only in the last few years have members of Congress begun challenging the “*mis-taken idea that taxes pay for a hundred percent of government expenditure.*”

According to **MMT**, all dollars are spent into existence by the federal government first and taxed out of existence later. When the federal government taxes dollars, it does not collect them— it destroys them. This destruction of dollars serves an existentially important purpose: it guarantees private demand for the dollar, which otherwise has no determinable minimum value. Companies, households, and other currency users must pay their federal taxes in dollars to the currency issuer or else face severe punishment. The dollar’s unique ability to cancel tax obligations becomes its stable baseline value in the private market.

The federal government, of course, does not tax itself. It has as much need for its own dollars as a teacher does for their own brownie points. As the currency issuer, the federal government never collects its own dollars because its purpose is to allocate them. It *must* spend more dollars into the economy than it taxes out, or else dollars would drain from the economy until none existed. When considering how many dollars to spend into existence, the federal government’s true concern is whether the new dollars will dilute the currency, causing inflation.

The question of inflation is a question of resources, not quantity of dollars. If a new dollar raises demand for goods or services more than it raises or conserves the supply of goods or services, then it is likely inflationary. Conversely, a dollar that preserves or creates resources more than it raises demand will expand the fiscal space of the entire economy. Such spending is likely non-infla-



tionary, which means that no new taxes are needed to offset the new dollars. The simple fact that federal taxes do not finance federal spending has enormous implications for lawyers and judges, especially within the field of environmental law.

The Law and Political Economy Project recently invited legal experts to contribute to a symposium on **cost-benefit analysis (CBA)**. The purpose of CBA rests on the reasonable idea that “*a regulation’s costs should not exceed its benefits.*” And yet, as scholars for the symposium note, CBA often draws abhorrent, arbitrary, and ridiculous conclusions. The Department of Justice asked people how much money they would accept to become victims of rape or sexual assault so that it could put a monetary value upon the benefits of rape prevention.

Monetary measurements of the “*statistical value of a human life*” imply that federal dollars spent on communities of younger or healthier people have more benefits than dollars spent on communities with older or sicker people. Richard Posner “conservatively” estimated the value of preventing human extinction at \$600 trillion.

The fountainhead of this stream of absurdities is the fundamental irrationality of federal CBA: **a fiat currency issuer measuring costs and benefits in its own currency, which has no independent value to the issuer.** The federal government need only weigh the real positive and negative consequences of the desired policy goal and then consider potential inflation, the actual “cost.” Inflation cannot be measured in total dollars because inflation is not caused simply by more dollars entering the economy than leaving.

Without addressing the true behavior of fiat currency, reforms to CBA may fail to escape its twisted logic. For example, CBA often reinforces inequity by valuing benefits to poor people less than benefits to rich people, who can earn more dollars in their free time. One proposed solution to this problem is “*distributional weights*”: the federal government assigns a greater numerical value to dollars given to poorer people than dollars given to richer people. Already, the concept of assigning different dollar values to different dollars begins to expose the arbitrariness of the currency to the currency issuer. However, distributional weights still require the federal government to think in terms of dollars, and the idea fails to address inflation as a true constraint. A dollar spent on a poorer person may be inflationary if it will raise demand for certain goods or services that face real supply constraints. Rather than simply assign that dollar a different numerical value, an effective solution would include fixing those supply constraints, which may, in fact, require more spending.

Some MMT economists recommend an alternative to CBA called “*cost-effectiveness analysis (CEA)*,” which does not convert desired benefits into dollar signs. In this kind of analysis,

“the ends are determined outside the economics, say by a democratic process informed by scientific information regarding the biophysical limits.”

The benefit of a log to the federal government is not the price of a log paid by private buyers, and the cost of felling a tree is not the price somebody is willing to pay to conserve the tree in a hypothetical and perverse tree market. The federal government must instead compare the real benefits and costs of both the log and the tree. When the government ultimately decides to either cut or conserve the tree, CEA would advise doing so in a cost-effective manner so as to minimize outside inflation risks. But the initial measurement cannot be made solely in dollars.

As currency users who need dollars to live and pay taxes, we are so used to measuring value in dollars that we forget it is possible to compare apples and oranges without using numbers. Before a teacher awards brownie points to students who clean up a mess, the teacher would not ask themselves the brownie point value of a clean classroom. The teacher understands that the points are a tool they wield to achieve or approach a desired vision. Likewise, the federal government should not ask itself the dollar price of goods and services; dollars are a tool the federal government invents precisely to conjure those goods and services.

By strictly doing cost-benefit analysis in dollars, the federal government forgets the purpose of fiat currency and the wisdom of the teacher. It forgets that the value of a life is a life, and the value of the Earth is the Earth. It forgets that such value is knowable, even without numbers.

James C. Ryan
law.georgetown.edu

Federal Reserve

Smoke & Mirrors

A large percentage of the money supply is created from bank deposits. All the Federal Reserve has to do is increase or decrease bank deposits, to increase or decrease the money supply.

Most of the money deposited in banks is not kept by banks, it is loaned out, increasing the money available to be spent, which has the effect of increasing the money supply of the country.

An example of how this works: Person A deposits \$100 in a bank, which means he has \$100 he can spend. In accordance with Federal Reserve regulations, the bank is allowed to loan up to 90% of this deposited money to someone else, say, Person B.

Once Person B has \$90 in his bank account, this makes a total of \$190 available to be spent. But his bank can loan up to \$81 (90% of \$90) to someone else. Now a total of \$271 is available to be spent. And so on. In this way, the dollars that are deposited in a bank will, eventually, end up creating many more dollars in circulating money.

The Federal Reserve can increase the money supply by increasing bank deposits, decrease the money supply by decreasing bank deposits. They do so, indirectly, by buying and selling bonds. A bond is a type of IOU.

The U.S. government borrows a huge amount of money by having the U.S. Treasury issue various types of bonds. To borrow money for a short amount of time (defined as one year or less), the Treasury issues what are called “Treasury bills.” To borrow money for a medium length of time (between one and 10 years), it issues “Treasury notes.” To borrow money for a long period of time (over 10 years), it issues “Treasury bonds.”

The reason the Fed can manipulate the system is that only money in the form of cash can be loaned out. Money in the form of bonds cannot be loaned out. Since bond money stays where it is, it does not circulate and, hence, does not increase the money supply.

Thus, it is possible for the Federal Reserve to control the size of the money supply by controlling how much money the banks keep in cash (which is loanable) compared to how much money they keep in bonds (which is not loanable). To increase the money supply, the Fed moves money from bonds into cash. To decrease the money supply, the Fed moves money from cash to bonds. The details are complex, but the basic idea is that each day, the Fed buys (or sells) several billion dollars worth of U.S. Treasury bonds from (or to) certain financial companies who act as dealers.

Where does the Fed get all the money to buy and sell such large quantities of Treasury bonds? The Fed doesn’t really have the money; the Fed just makes it up.

It is allowed to credit accounts without having to come up with real money. Thus, when the Fed puts a \$4 billion credit in the bank account of a bond dealer, the money doesn’t have to come from anywhere. The mere fact that the Fed puts it in a bank account is enough to create the money. Similarly, when the Fed takes \$4 billion out of a bank account, the money doesn’t go anywhere. It just ceases to exist. And that is the key that makes the whole thing work.

It’s all an illusion.