The Impact of Relying Solely On the Central Bank to Print New Money

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Abstract. Taxation is a compulsory contribution to state fiscal revenue. Money-printing, technically known as monetization or "money-financed fiscal programs," occurs when the government finances itself by issuing non-interest-bearing liabilities in the forms of currencies or reserves held at the central bank. These two concepts align with the government's two approaches to influencing economic activity: monetary policy, which pertains to money supply and interest rates level, and fiscal policy, primarily centered around taxation. Therefore, the purpose of this topic is to discuss why governments should be regulated by legal prohibitions against monetary financing and why countries have instituted the independence of the central bank. This study will analyze the advantages and disadvantages in question and provide insights into the ideal role of the government and the appropriate approaches to fulfilling its responsibility in economic regulation.

Keywords: Taxation; Money-printing; Central Bank.

1. Introduction

To illustrate the advantages and disadvantages of replacing taxation with money created by the central bank, it is essential to define these economic policies. According to Merriam-Webster Dictionary, "taxation" encompasses all forms of involuntary levies imposed by authority on individuals,property,workerincome,and business profits, or added to the cost of some goods, service s, and transactions (Merriam-Webster Incorporated, 2023). As suggested by the topic, in accordance with the provisions of the law, taxation is a compulsory contribution to state fiscal revenue, which funds the government's expenditure to provide public goods to society, meet the common needs of society, and participate in the distribution of social products. On the other hand, money-printing, technically known as monetization or "money-financed fiscal programs," occurs when the government finances itself by issuing non-interest-bearing liabilities in the forms of currencies or reserves held at the central bank (Lawson, A., & Feldberg, G,2023). This macroeconomic regulation strategy is typically employed by the state to boost domestic demand, increase consumption, and supplement government spending. These two concepts align with the government's two approaches to influencing economic activity: monetary policy, which pertains to money supply and interest rates level, and fiscal policy, primarily centered around taxation. Therefore, the purpose of this topic is to discuss why governments should be regulated by legal prohibitions against monetary financing and why countries have instituted the independence of the central bank. This study will analyze the advantages and disadvantages in question and provide insights into the ideal role of the government and the appropriate approaches to fulfilling its responsibility in economic regulation.

2. Advantages

As indicated by their definition, taxation has traditionally been considered the dominant source of government revenue, while money creation might be applied as a supplementary measure. However, the economic realities of the pandemic period have demonstrated a notable advantage in replacing taxation with money printing: it provides governments with a greater degree of flexibility that governments in funding their expenditures. This enables the state to function and fulfill its responsibility, especially in times of economic depression, emergencies, and when tax revenues are insufficient. A historical example of such flexibility can be observed in the United States during the wartime period in 1942 (see Figure 1). Congress amended the provisions of the Banking Act, allowing federal banks to purchase government debt, specifying that their total holdings should not exceed $5 billion. This exemption was periodically extended, albeit with time limitations, until it eventually expired in June 1981(Garbade & Kenneth D,2014). Another recent example is the response to the COVID-19 pandemic. To address the increased need for public spending in combating the crisis, Bank Indonesia reached an agreement in July 2020 to acquire around 398 trillion rupiahs (equivalent to US$27.4 billion) in bonds, with all interest payments being returned to the government. Additionally, the central bank committed to covering a portion of the interest payments on an additional 123.46 trillion rupiahs worth of bonds (Sihombing, G & Sipahutar, T.,2020).

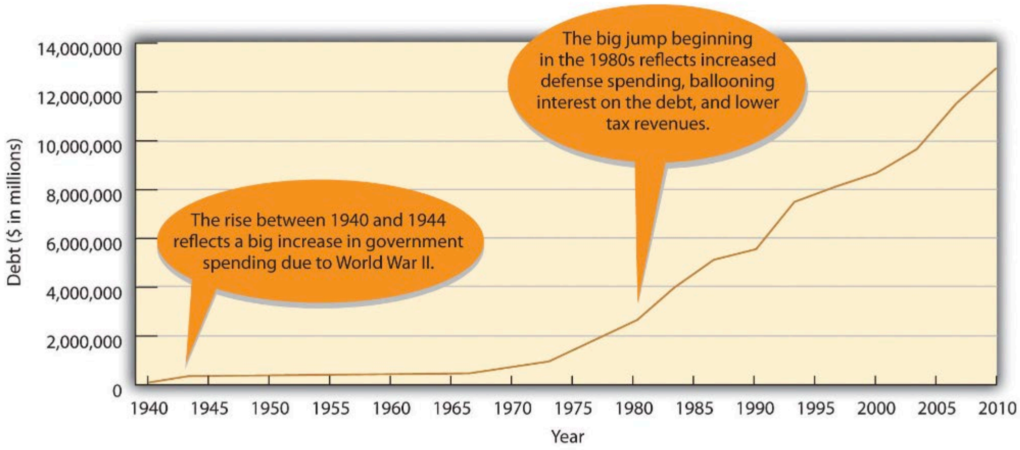

Fig.1 The U.S. National Debt, 1940- 2010

3. Disadvantages

On the contrary, completely replacing taxation with money printing as the sole method of generating government income could have significant drawbacks. One such disadvantage is the loss of central bank independence. Although some scholars argue that the necessity of addressing crises outweighs the importance of upholding monetary discipline in the aforementioned cases(Galí, J., 2020; Grauwe, P. D., & Diessner, S., 2023; Turner, A.,2020), the reality is that there are legal prohibitions against monetary financing in various forms. These include Article 123 of the Lisbon Treaty in the Eurozone (European Central Bank, 2016), the Banking Act of 1935 in the U.S. (Garbade&Kenneth D, 2014), the prohibition of debt monetization in Japan (Mainichi Broadcasting System, 2020), and the People's Bank of China Law of 1995 in China (Government of the People's Republic of China, 2004). The principle of central bank independence could be illustrated by demonstrating the process of money printing. For example, in China, the head office of the People's Bank of China formulates a currency demand plan based on the approved national currency issuance plan, taking into account factors such as the destruction of damaged currency and changes in the inventory of issuance fund (Daodou Library, 2022). The currency printing management department prepares a currency printing plan and oversees its implementation based on the currency demand plan. In 2022, a total of 20.91 trillion RMB was printed in China, and this calculation was based on a complex formula involving the price of goods in circulation and the flow of social goods, which could be expressed as follows: the amount of money needed for circulation = the total price of the commodity ÷ the number of times the currency circulates(The People'sBank of China, 2023). However, unwanted government intervention in a free-market economy would result in the loss of the central bank's independence, as the governments driven by short-term political gains, such as increasing popularity, may resort to money printing whenever needed. This would lead to the second disadvantage of the replacement mentioned in the question.

Secondly, if unrestricted money printing occurs, the consequent increase in the money supply would result in a decline in the currency's value and inflationary pressures within the economy, potentially leading to hyperinflation. As mentioned above, if a government relies solely on money printed by the central bank to constitute the majority of its revenue, as is the case with China, where it contributes to 75.5% of the income, (State Taxation Administration, 2021) there is a risk of excessive currency printing when fiscal revenue falls short of the nation's demands. In such a scenario, an unchecked money supply can trigger high inflation, particularly if the economy's supply side is weak or constrained, preventing output growth, or if the government accumulates substantial foreign debt and experiences rising fiscal deficits. When runaway inflation takes hold in a country, the devaluation of its currency could further lead to the collapse of its exchange rate and a sharp increase in the prices of essential imported goods. This, in turn, might accelerate domestic inflation, creating a vicious circle that eventually culminates in hyperinflation (Coppola, F.2022). Venezuela provides a prime example of hyperinflation primarily caused by misguided public policies involving excessive money printing (Carmody, M.,2019). Faced with an economic crisis triggered by oil prices, the Venezuelan government resorted to printing money to sustain itself and to maintain an illusion of prosperity to preserve order and its political position. According to Reuters, Venezuela's broad monetary aggregate reached 13.3 trillion bolivars on 24 March, 2017, making a 202.9% increase from the previous year (Strait Metropolitan Post, 2017). In 2019, inflation reached a peak of approximately 300,000% (Xinhua News Agency, 2017). As the authorities continued to print money without limits, the economic crisis worsened, leading to social unrest. Consequently, the living standard of citizens deteriorated, with a significant portion of the population experiencing shortages of food, fuel, and medicine. Businesses struggled to cover the cost of raw materials and labor workers, and investment dwindled as capital fled the country in search of safer havens (Foundation for Economic Education, 2021). Another comparable example would be observed in the runaway inflation experienced by the Weimar Republic in Germany (Redeker, N.&Haffert, L., & Rommel, T., 2019). As demonstrated in the flowing figure, after the end of World War I, Germany suffered from hyperinflation, resulting in severe depression, widespread poverty, and unemployment, ultimately providing the backdrop of the rise of the Nazi party (Heimberger, P., 2021).

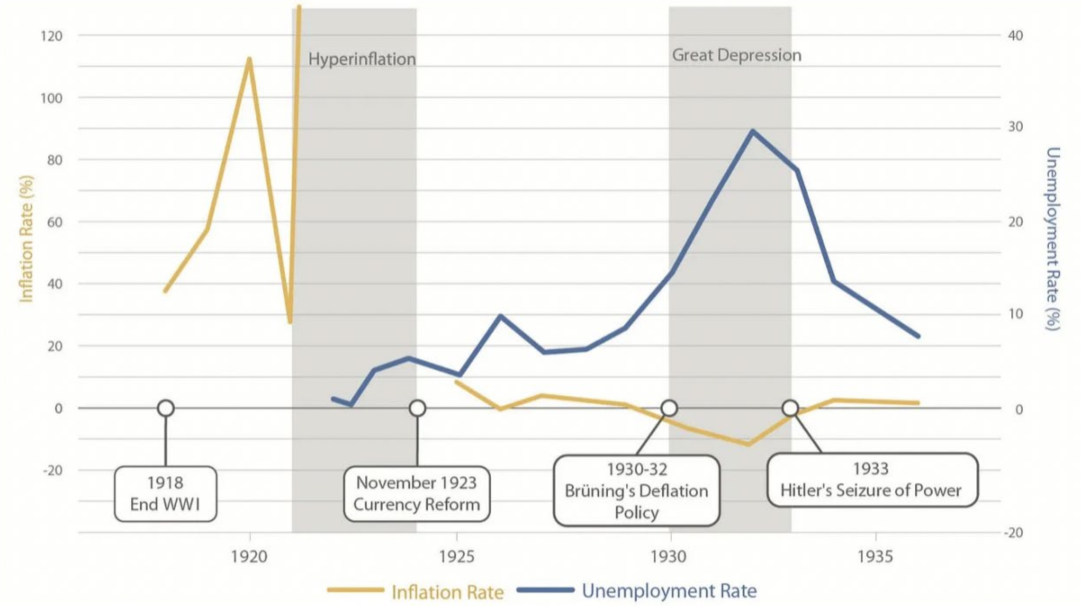

Fig. 2 The economic background of the rise of Nazis, 1910-1940

However, why taxation would not lead to the aforementioned problem is a question that needs to be addressed. A substantial body of empirical analysis demonstrates that taxation could be less likely to be completely replaced by debt monetization due to one key advantage of the taxation system: stability. The tax system in many economic entities is widely recognized for its maturity and integrity. For example, the data from the State Administration of Taxation of China reveals that taxes contribute to approximately 75.5% of the government's income (State Taxation Administration, 2021). Taxation, as a vital component of fiscal policy, covers almost all domains of economic activities, allowing the state to implement comprehensive regulation and fulfill its duty of regulating the economy. The indispensable role of taxation could be demonstrated by the well-established taxation system. For instance, the Chinese taxation system encompasses 18 taxes categorized into five groups, including turnover tax and income tax, as depicted in the graph below, based on the taxation regulations from the National People's Congress (NPC) and the State Administration of Taxation (State Taxation Administration, 2019.)

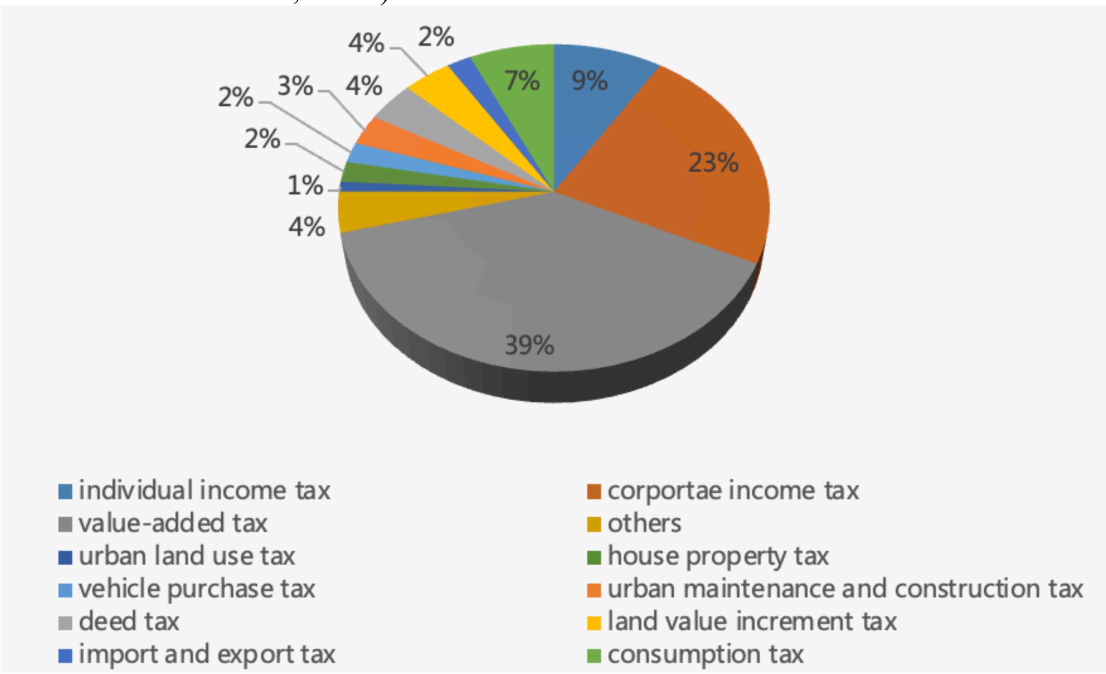

Fig. 3 The tax composition of China in 2018

The stability of the taxation system is also ensured by a comprehensive legal framework, a robust taxation law system, and administrative penalties. For example, the Chinese authorities have implemented a significant principle: the enactment of specific tax laws or administrative regulations corresponding to each type of tax. This has resulted in a stringent regulation of the entire tax revenue process, and this rigorous regulation could be reflected in the supervision of taxpayers carried out by the tax inspection department. In addition, a series of administrative penalties have been conducted by these departments on individuals found guilty of tax evasion (State Taxation Administration, 2018). This strict oversight by prosecutors contributes to the stability of tax revenue. In contrast, printing money might not provide such reliable support, either for the government or for the growth of the economy under its supervision, which could be a significant disadvantage that should not be overlooked. One reason is the volatility caused by fluctuating currency circulation within the economic system, as the unstable amount of money supply could have severe repercussions for the domestic economy.

4. Conclusion

Perhaps it is the current state of the economy in today's post-epidemic era that prompts us to start to reevaluate the extent of government control over the economy, the level of independent central banks should maintain, and the actual impact of government macro-regulation on the free development of economic life. The most recent manifestation of this is the emergence of the epidemic crisis, which necessitates increased government intervention in the economy to support and regulate economic activity. In such extreme circumstances, governments bolster their fiscal reserves, strength, and crisis response capabilities by resorting to money printing in the midst of a crisis. However, it is important to recognize that money printing is not a permanent solution for generating government revenue. Excessive government intervention in the free-market economy and the loss of central bank independence can have detrimental effects that cannot be ignored, potentially requiring an extended period of economic regulation to mitigate these negative consequences.

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