Reinventing Functional Finance
Transformational Growth and Full Employment

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Preface

In 1941, Professor Abba Lerner of the University of Kansas City (later the University of Missouri–Kansas City) laid out the principles that he believed should guide the government’s budgetary policies. These principles, spelled out in his article, 'The Economic Steering Wheel,' which appeared in the University of Kansas City Review, were offered as an alternative to the orthodox principles of so-called ‘sound finance.’ Lerner later moved to the New School for Social Research where he elaborated his ideas in ‘Functional Finance and the Federal Debt,’ published in 1943 in the New School’s Graduate Faculty journal, Social Research.

The New School’s Program on Transformational Growth and Full Employment, under the direction of Edward J. Nell, Malcolm B. Smith Professor of Economics, has revived the tradition that Lerner began. Part of this revival, a conference on ‘Functional Finance and Full Employment,’ was held in the spring of 1995 at the New School, attracting economists from around the globe. The conference re-examined monetary and fiscal relationships — both in theory and policy — in the light of Lerner’s prescient principles.

Among the participants were Harvard University Professors Richard Musgrave, the father of modern public finance, and James Duesenberry, best known for formulating the relative income hypothesis, an alternative to the permanent income and life-cycle theories of consumption. The late Robert Eisner of Northwestern University, former President of the American Economic Association, and the late Lynn Truog of Hofstra University both presented papers at the conference. This would be the last such activity for both of these important scholars of fiscal and budgetary policy. David Colander of Middlebury College, who collaborated with Abba Lerner, presented a paper, and the New School’s own Robert Heilbroner, whose book on the deficit influenced President John F. Kennedy, gave a talk, and both took part in the roundtable discussions.

In ‘Functional finance and the federal debt,’ Lerner proposed his principles of functional finance, which he believed the government should implement to bring about full employment:

The central idea is that government fiscal policy, its spending and taxing, borrowing and repaying of loans, its issue of new money and its withdrawal of money, should all be undertaken with an eye only to the results of these actions on the economy, and not to any established traditional doctrine about what is sound and what
advocacy of desired objectives without making it clear that this is being done or making it clear whose are the desires being considered. (1969: 131)

Lerner (1941) likened laissez-faire to a refusal to take hold of the 'economic steering wheel.' Government must use its powers to 'fill its two great responsibilities, the prevention of depression, and the maintenance of the value of money' (1947: 314).

Lerner's arguments for full employment are worth reviewing. First, 'the economic gains from full employment are enormous' (1951: 31–32). The costs of unemployment are staggering. They include not only the permanent loss of output in goods and services, but also the social costs resulting from increased crime, illness and other social problems.

Full employment increases efficiency. Removing the threat imposed on workers by the existence of a reserve army of unemployed, workers will feel more confident to move out of one job and into another. This often means a movement from a lower productivity job to a higher productivity job (1951: 32).

Individual economic security is an even more important benefit than the increase in goods and services (1951: 33). Though the foremost gain is individual economic security for workers, government commitment to full employment has an important stabilizing impact on business confidence derived from the awareness that the state is committed to maintaining aggregate demand (1951: 33).

A full-employment policy weakens racial and other hiring discriminations (1951: 36). There are incentives in an economic system characterized by general unemployment for workers to seek ways of 'tying up the jobs they have so they cannot be easily fired' (1951: 34). 'The economic interest of a group of workers in protecting their scarce jobs against competition from outside,' so often conducted through racial and other discrimination, would be significantly decreased with the elimination of job scarcity (1951: 36–37). In addition, employers, who have the opportunity to indulge their own racial and other prejudices in hiring when there is widespread unemployment, would no longer be able to do so in a full-employment economy (1951: 36). Full employment also helps to remove wage differentials, acknowledged to be highly related to race and gender (1951: 37).

Full employment is key to social stability (1951: 37ff.). Without employment and income security, citizens are vulnerable to dangerous ideologies, to scapegoating and to anti-democratic political movements.

Full employment and the maintenance of the value of currency are the key initial prerequisites for a decent standard of living for all. To leave such matters to the market would be like driving a car without using the steering wheel. Fortunately, people do not drive their cars without using their steering wheels.
But are they as reasonable about other things as they are about the desirability of steering their automobiles? ... Do they not allow their economic automobiles to bounce from depression to inflation in wide and uncontrolled arcs? Through their failure to steer away from unemployment and idle factories are they not just as guilty of public injury and insecurity as the mad motorists ...? (Lerner, 1951: 4-5)

Lesson #2: Policies should be judged on their ability to achieve the goals for which they are designed and not on any notion of whether they are ‘sound’ or otherwise comply with the dogmas of traditional economics.

This, of course, is Lerner’s functional finance (1943). The state has the ability to promote full employment and price stability and should use its powers to do so:

The central idea is that government fiscal policy, its spending and taxing, its borrowing and repayment of loans, its issue of new money and its withdrawal of money, shall all be undertaken with an eye only to the results of these actions on the economy and not to any established traditional doctrine about what is sound and what is unsound. This principle of judging only by results has been applied in many other fields of human activity, where it is known as the method of science opposed to scholasticism. The principle of judging fiscal measures by the way they work or adjust its rates of expenditure and taxation such that total spending in the economy is neither too more nor less than that which is sufficient to purchase the full employment level of output at current prices. If this means there is a deficit, greater borrowing, then these things in themselves are neither good nor bad, but simply the means to the desired ends of full employment and price stability. (1943: 354)

This principle is so simple, yet apparently so difficult to understand. Support of balancing the budget as the proper means for achieving some economic goal is entirely consistent with the principle of functional finance. The balanced budget, however, is not ‘sacred,’ but simply a means to the desired ends. Those who support a balanced budget should thus agree, in principle, that if some other relation between government expenditure and tax receipts were the best means to attaining those ends, the balanced budget should be abandoned and those other means instituted. But if one promotes a balanced budget as an end in itself – as the ‘right’ thing to do – it becomes ‘irresponsible’ to do otherwise, despite potential effects and the sacrifice of macro goals. This is not consistent with the principle of functional finance. It is best referred to as dysfunctional finance.

Opposition to government borrowing, lending, taxing, spending, buying or selling should be based on evidence that such actions cause unemployment, inflation, deflation or some other undesirable macroeconomic outcome, or because they hinder the abolition of these undesirable macroeconomic problems.

But if any of those means promotes the desired macro goals or prevents undesirable macro problems, then they should be utilized for that purpose. There is nothing inherently ‘good’ or ‘bad’ about any particular relation between government expenditure and tax receipts. Rather, effects derive from the specific economic circumstances and on the results that such a relation will promote under those circumstances. If the amount of taxing, spending, borrowing, lending, buying or selling ‘should conflict with the principles of “sound finance” or of balancing the budget or of limiting the national debt, so much the worse for those principles’ (1951: 11).

Lesson #3: Without a full employment policy, society cannot benefit from labor-saving technological advance, that is, efficiency becomes inefficient. With a full employment policy, labor-saving technical advance becomes truly beneficial to society.

Under conditions of continuous full employment, resources are scarce. Thus instituting technical or organizational innovations to free up labor for other uses constitutes a welcome economizing of resources. But in an economy with persistent unemployment, what is efficient becomes inefficient:

When there is unemployment ... it is not important or even useful to use less resources in any task. ... There is no point, for instance, in managing to carry out some task with less labor if there are unemployed workers available, because the workers set free would not be utilized for other tasks any more than the workers who are already unemployed. They would merely be added to the unemployed. Where there is unemployment, an increase in efficiency in any particular productive process does not result in any increase in the efficiency in the economy as a whole. (1951: 143).

Lerner does consider the possibility that, rather than producing the same amount of output with fewer workers, society could produce more output while maintaining the same number of workers. Yet as he rightly points out, though increased saving results from increased income accompanying higher output levels – absent an exactly offsetting higher level of investment or government expenditure – the new higher level of output will not be sustainable, as all production will not be sold, and firms will cut back their production and lay off workers. In the absence of a full employment policy:

Economizing resources by the use of more efficient methods is like pouring water into a broken vessel with a large hole in it that is already holding as much as it can hold. No matter how much more is poured into it there will remain no more than at the beginning. The savings due to greater technical efficiency merely go to waste in further unemployment just as any additional water merely goes to waste through the hole. (1951: 144)
Nor is it the case that such technical advances are merely neutral. They may also be harmful. First, rather than making more leisure possible with labor-displacing technical advance ‘what we get is not the tranquillity of refraining from effort but the frustration of failing to find work. In every socially significant sense the increase in efficiency brings not greater happiness but greater misery’ (1951: 144). Second, labor-displacing technical advance may result in lower aggregate output and income. This can occur if technical change leads to redistribution of income from wages to profits, or from those with a higher marginal propensity to consume to those with a lower marginal propensity to consume. In such a case, aggregate spending will decline, reducing effective demand, and thus aggregate output and income (1951: 144–45). With a true full employment policy in place however, labor-displacing technical change is truly efficient, since the increased efficiency will not result in unemployment. Thus, technical advance can be welcomed by society, as it is truly beneficial.

Lesson #4: Without a full employment policy, a country must suffer over its trade balance. With a full employment policy, there is no need to worry about importing ‘too much’ relative to exports.

In the absence of full employment guaranteed by functional finance, a country must worry about rising unemployment stemming from an increase in the value of imports over the value of exports. Thus an excess of imports over exports is considered an ‘unfavorable balance of trade’ and the reverse is considered a ‘favorable balance of trade.’ But Lerner looks at foreign trade as ‘the means by which we obtain for our own use goods that are manufactured abroad’ (1951: 321): ‘The input of the foreign-trade industry consists of the effort involved in the manufacture of our exports. … The output of the foreign-trade industry consists of the imports which it yields to us for our use’ (1951: 321, original emphasis). In other words, exports are a cost and imports a benefit. Thus with a real commitment to full employment, an increase in a country’s imports relative to its exports is an increase in its benefits. It is only without a full employment policy that this is undermined, as such a development will have a negative impact on aggregate demand, output, income and employment. Countries therefore attempt to increase employment through promoting exports and restricting imports, that is, by promoting costs and restricting benefits.

The idea that a country can cure unemployment only by developing an export surplus is completely baseless unless the society has developed a taboo against every other way of increasing the level of spending. Functional Finance dissolves any ‘imported unemployment’ (1951: 327, 332).

Lesson #5: To achieve full employment, government spending may have to include direct job creation.

Traditional fiscal and monetary policies may be ineffective in achieving full employment. Direct job creation in the form of public works may be necessary in order to attain and maintain full employment and price stability (1944: 315ff). Even public employment that produces no visible good or service is beneficial, in that it still creates jobs for the unemployed and increases aggregate output and income, with all their associated benefits. However, since there are so many public and social services that benefit the economy and society in numerous ways and are not normally undertaken by the private sector, there is no reason that public employment should ever have to be unproductive (see 1951: 90ff).

Public works can increase the productivity of the private sector. In addition, public employment is key to accommodating the reluctance of individuals to disrupt family and community by relocating to find employment.

Lesson #6: Functional Finance is not a policy; it is a framework within which all sorts of policies may be conducted.

There may be misconceptions that functional finance is equated with a particular policy, for example, running a big deficit. Functional finance is rather a general approach within which a whole series of policies may be conducted. The actual policies implemented will depend on economic circumstances that exist at a particular time. In the functional finance outlook what matters are the effects of policies and not the policies themselves, which are mere means. Thus functional finance does not advocate big deficits under any and all circumstances. Nor does it view a balanced budget as inherently ‘good’ in and of itself, independently of its impact on the economy.

What functional finance advocates first and foremost is that policy be based on an understanding of the monetary and financial system in which we live, and not some idealized vision of some other system, or some system that may have existed at some other time. For example, if fiscal and monetary policy is formulated as if we were on a gold standard, we not only will sacrifice tremendous potential benefits, we may subject ourselves to grave danger. A fiat currency system should not be run by the logic of a metallic standard system.

Lesson #7: ‘Money is a creature of the state.’

The ability of the government to conduct fiscal and monetary policy according to the principles of functional finance is made possible by the fact that ‘money is a creature of the state’ (1947). The state has the power not only to tax, but to designate what will suffice to retire tax (and other) obligations, that is, what it will accept at its pay offices. By determining public receivability, the state can create a demand for otherwise worthless pieces of paper, leading
to general acceptability. The state can issue this currency and use it to purchase goods and services from the private sector:

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 is 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. Everyone who has obligations to the state will be willing to accept the pieces of paper with which he can settle the obligations, and all other people will be willing to accept those pieces of paper because they know that taxpayers, etc., will accept them in turn. On the other hand if the state should decline to accept some kind of money in payment of obligations to itself, it is difficult to believe that it would retain much of its general acceptability. ... 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. (1947: 313)

Thus, a variety of state powers - such as government's ability to tax, declare public receivability, create and destroy money, buy and sell bonds and administer the prices it pays for goods and services purchased from the private sector - constitutes a menu of instruments with which full employment and stability of the value of the currency may be promoted.

Lesson #8: Taxing is not a funding operation.

Since money is a creature of the state and the government budget should be judged purely on its macroeconomic effects, decisions concerning taxation should be made only with regard to the economic effects in terms of the promotion of full employment, price stability or other economic goals, and not ever 'because the government needs to make money payments' (1943: 354): 'Taxes should never be imposed for the sake of the tax revenues' (1951: 131, original emphasis).

Lesson #9: Government borrowing is not a funding operation.

Similarly, for the same reasons as taxation, Lerner argued that 'borrowing' is not a funding operation. Since it is not a funding operation, it is questionable whether we should even use the term 'borrowing.' Perhaps it would be best to simply refer to bond sales. Thus Lerner argued that 'the government should borrow only if ... the effects' of borrowing are desired (1943: 355).

Lesson #10: The primary purpose of taxation is to influence the behavior of the public.

If taxation is not a funding operation, then what is its purpose? The purpose of taxation, according to Lerner, is 'its effect on the public of influencing their economic behavior' (1951: 131, original emphasis). First, through its power to determine public receivability, the government can create sellers who will offer goods and services for sale in exchange for the government currency. Thus taxation, as mentioned above, endows otherwise worthless bits of paper with value. Another important way in which taxation affects the public's behavior is through its impact on spending. In the days when Lerner was much concerned with excess demand inflation, this was a major focus. But taxation can affect behavior in many other ways (e.g., taxes on 'bads' are implemented to discourage certain behaviors). For Lerner, this reality, and not funding of government spending, is its primary function.

Lesson #11: The primary purpose of government bond sales is to regulate the overnight interest rate.

As we have seen, for Lerner, neither taxation nor government bond sales are funding operations. Taxation creates a demand for State money, and also can be used to fine-tune spending and affect other public behavior. What is the purpose of government bond sales if not to fund government spending? For Lerner, the primary purpose of bond sales is to manage reserves and thus the overnight rate of interest (inter-bank lending rate) in the face of government fiscal operations. The government should sell bonds, writes Lerner, 'if otherwise the rate of interest would be too low' (1943: 355).

Lesson #12: Bond sales logically follow from, rather than precede, government spending.

Since government need not 'borrow' to finance its expenditure, relying instead on bond sales to manage bank reserves and hit some target rate of interest, logically speaking, bond sales follow from rather than precede government spending:

[T]he spending of money... out of deficits keeps on increasing the stock of money (and bank reserves) and this keeps on pushing down the rate of interest. Somehow the government must prevent the rate of interest from being pushed down by the additions to the stock of money coming from its own expenditures... There is an obvious way of doing this. The government can borrow back the money it is spending. (1951: 10–11, original emphasis)

By selling bonds, government can drain the banking system of excess reserves created by its own deficit spending, and thus prevent the rate of interest from falling to zero bid. Such a process clearly supports the view that,
far from selling bonds in order to finance expenditure, bond sales logically follow from spending by the government.

Lesson #13: ‘Printing money’ is and of itself has no impact on the economy whatsoever.

For Lerner, there are six (or three pairs of) fiscal instruments of government: taxing and spending, buying and selling, borrowing and lending. ‘Printing money’ is not independent of these. Therefore, printing money, in and of itself, has no impact on the economy whatsoever. Suppose the government prints money and puts it in a rocket ship and blasts it to the moon. Will the printing of money have had any effect on the economy? Of course not.

[The creation of money has no effects on the economy as long as the printed money remains in the print shop. It is only when the money gets out into the economy that any effects come about. Money which is newly created and kept locked up might as well never have been created. (1951: 132)]

Only if the money printed is spent on goods and services or lent through issuing bonds or otherwise given away will there be some economic impact, but these impacts are already covered through the consideration of the six fiscal instruments: ‘The printing of money is not an instrument of policy. It is only a servant of these policies, just like printing stationery used in the various government departments’ (1944: 312–14):

All the decisions of any importance are made when it is decided to apply the fiscal instruments. . . . If any of the instruments involves the paying out of money . . . the effects are just the same whether the money paid out was previously resting in the treasury or whether it had to be printed because there was not enough available in the treasury to permit them to be carried out on the scale that was considered necessary to prevent deflation. The use of the instrument should never be hampered just because there may not be enough money stock in the treasury at the moment. To sacrifice the prevention of deflation because of shortage of money which could be printed is no more sensible than to refrain from carrying out any other important government action because the necessary paper forms or stationery would have to be printed. (1951: 133)

Lesson #14: When there is unemployment, jobs and money, not resources and goods, are scarce.

In a full employment economy, resources are scarce. Economizing is important, as resources can only be allocated to any use if they are removed from some other productive activity. In an economic system with unemployment, however, goods are not scarce, as more can be produced by employing the unemployed resources. But there are further scarcities in an economy suffering from unemployment:

What is scarce is money. The lack of money to spend on the goods is what keeps the unemployed resources from producing more goods. Work, moreover, instead of being a curse, is desired more than anything else because the alternative is not the enjoyment of leisure but the suffering of unemployment and deprivation. Of course, if people could get income without having to work they would not object too much (although their self-respect in feeling they are useful members of society who are earning their income is too easily underestimated). But it is only by finding work that they can obtain the necessary income they need. (1951: 147–48)

Lesson #15: Attempts to argue that the deficit and debt are not really as big as they look, or that if we measure them differently or keep a capital account, they are not really that bad, are counterproductive.

For Lerner, ‘deficit doves,’ by trying to placate concerns about government budget deficits and the national debt, actually do harm to their own position as ‘proponents of organized prosperity’ (1951: 15):

A kind of timidity makes them shrink from saying anything that might shock the respectable upholders of traditional doctrine and tempts them to disguise the new doctrine so that it might be easily mistaken for the old. This does not help much, for they are soon found out, and it hinders them because, in endeavoring to make the new doctrine appear harmless in the eyes of the upholders of tradition, they often damage their case. Thus instead of saying that the size of the national debt is of no great concern . . . [and] . . . that the budget may have to be unbalanced and that this is insignificant when compared with the attainment of prosperity, it is proposed to disguise an unbalanced budget (and therefore the size of the national debt) by having an elaborate system of annual, cyclical, capital, and other special budgets. (1951: 15)

For Lerner, even more dubious are those who declare their agreement with the principles of functional finance but waffle in their support because they believe the public will not understand; or those who claim that functional finance seems reasonable but believe there must be something wrong with it they are unable to uncover (1951: 16). The former tend to be ‘intellectuals’ who underestimate the public’s capacities, while the latter tend to be members of the public who hold intellectual adherents of sound finance in unwarranted high esteem. Both tendencies result in stalling policies for prosperity. Lerner compares the situation to the fable of the emperor with no clothes, in which the people are too timid or fearful to speak out. When it comes to functional finance:

The scholars who understand it hesitate to speak out boldly for fear that the people will not understand. The people, who understand it quite easily, also fear to speak out while they wait for the scholars to speak out first. The difference between our present situation and that of the story is that it is not an emperor but the people who are periodically made to go naked and hungry and insecure and discontented – a
ready prey to less timid organizers of discontent for the destruction of civilization. (1951: 16, original emphasis)

CONCLUSION

Abba Lerner’s work on functional finance and full employment contains lessons as relevant today as when they were put forward some five decades ago. At a time when orthodox theory and policy offer little to explain either causes or cures in the form of effective policy approaches, we could do well to revisit these ideas and the ideas of other great economics thinkers of the past. Of more than antiquarian interest, their work contains valuable lessons that can inform current analysis and formulation of approaches to macroeconomic policy.

The global economy is troubled by deflationary pressures, excess capacity, and growing unemployment. Lerner’s principles of functional finance, complemented by his state theory of money, serve as a guide to macroeconomic policies appropriate for the contemporary political economy that can increase aggregate demand and promote full employment and economic growth with stable prices. A public service employment program can be used to operate the economy based on the lessons learned from Lerner. Any nation can define its currency by the public service employment wage-benefits package, and the deficit can adjust to the private sector’s desire to net save. The economy can move directly to full employment, and socially beneficial community services will have all the labor power they need. There is no excuse for involuntary unemployment in today’s world: joblessness means only that we have not learned our lessons well.

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12. Anchors aweigh: from real to nominal money and from market to government stabilization

Edward J. Nell

The traditional monetary system was ‘anchored’ in precious metal. In the earlier forms of the system, the metal was mined and minted into coins until sufficient coins were in circulation for exchange against current goods and services. This proved to be expensive, so paper came to be substituted. But the value of the paper depended on that of the coins. That is, the value of the monetary unit was tied to the value of metal through the fact that the circulating medium could be converted into metal. This prevented ‘overissue’ of the paper currency, the correct issue being the amount needed to replace metal where that amount is determined by the needs of circulation.

Since prices were subject to a constraint, it was difficult for inflation to take root. But because the money supply depended on reserves, which had to be earned or obtained in the market, the system tended to be inflexible. For instance, it could not easily adapt to changing levels of activity. It also faced problems in raising the large sums of money needed for the construction of networks necessary for collective goods and services – classically, railroads, but later, telephones, radio, and television, not to mention highways. To reap the advantages of scale, these had to be built ahead of demand, amortized over long periods. Nor could the state issue money without backing, thus making it difficult for government to fulfill its new roles.

In the interest of flexibility, the anchor has been weighed; modern money is no longer convertible into anything else. We have a different kind of monetary system, one without a supply function for the article that serves as money. This has important consequences. First, the value of money must now be set exogenously (essentially inherited from history), but secondly, the rate of interest is no longer determined by the market. It cannot be determined by supply and demand, because there is no longer any supply function. Instead it is pegged by the central bank.

These changes have taken place in the context of a shift in technology in which generalized diminishing returns have been replaced by almost universal