What's Wrong With Functional Finance? (Wonkish)

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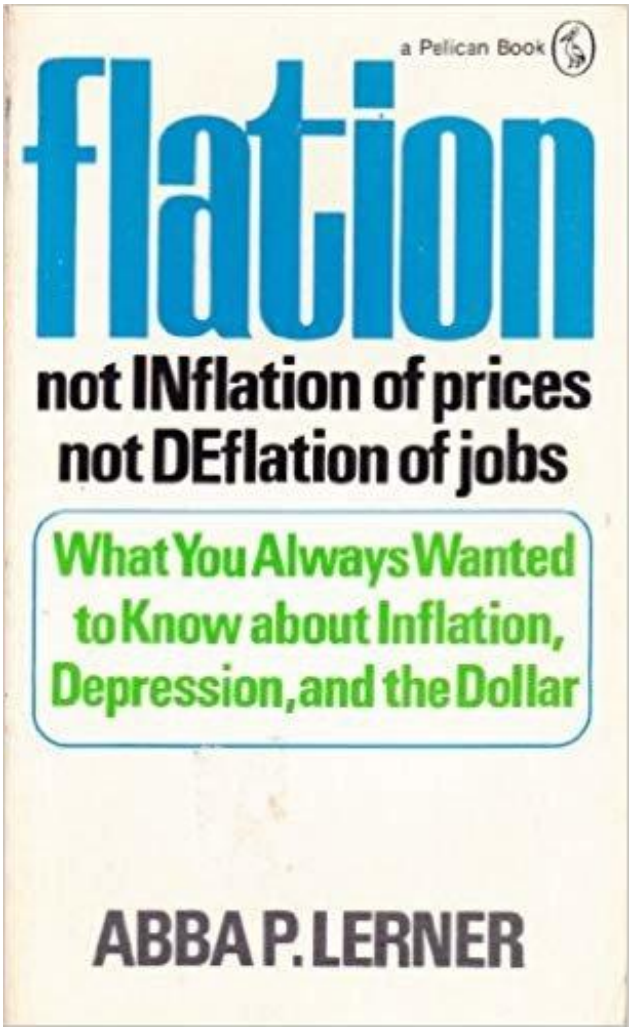
Paul Krugman, *The New York Times*, February 12, 2019



Well, it looks as if policy debates over the next couple of years will be at least somewhat affected by the doctrine of Modern Monetary Theory, which some progressives appear to believe means that they don't need to worry about how to pay for their initiatives. That's actually wrong even if you set aside concerns about MMT analysis, which is something I'll write about in a companion piece. But first it seems to me that I need to set out what's right and what's wrong about MMT.

Unfortunately, that's a very hard argument to have – modern MMTers are messianic in their claims to have proved even conventional Keynesianism wrong, tend to be unclear about what exactly their differences with conventional views are, and also have a strong habit of dismissing out of hand any attempt to make sense of what they're saying. The good news is that MMT seems to be pretty much the same thing as Abba Lerner's "functional finance" doctrine from 1943. And Lerner was admirably clear, making it easy to see both the important virtues of and the problems with his argument.

So what I want to do in this note is explain why I'm not a full believer in Lerner's functional finance; I think this critique applies to MMT as well, although if past debates are any indication, I will promptly be told that I don't understand, am a corrupt tool of the oligarchy, or something.

OK, Lerner: His argument was that countries that (a) rely on fiat money they control and (b) don't borrow in someone else's currency don't face any debt constraints, because they can always print money to service their debt. What they face, instead, is an inflation constraint: too much fiscal stimulus will cause an overheating economy. So their budget policies should be entirely focused on getting the level of aggregate demand right: the budget deficit should be big enough to produce full employment, but no so big as to produce inflationary overheating.

This is a smart take, and at the time he wrote – coming off the 1930s, with a reasonable expectation that the economy would lapse back into chronic weakness once the war was over – was a much better guide to policy than conventional fiscal thinking. And it also looks pretty good in today's world, where we once again had a long period of depressed demand despite zero interest rates and still look pretty fragile. Indeed, it looks vastly better than the "Eek! We're turning into Greece!" panic that dominated policy discussion for much of the 2010s.

So what are the problems? First, Lerner really neglected the tradeoff between monetary and fiscal policy. Second, while he did address the potential problem of snowballing debt, his response didn't fully address the limitations, both technical and political, on tax hikes and/or spending cuts. Introducing these limitations makes debt potentially more of a problem than he acknowledges.

From a modern perspective, "Functional finance" is really cavalier in its discussion of monetary policy. Lerner says that the interest rate should be set at the level that produces "the most desirable level of investment," and that fiscal policy should then be chosen to achieve full employment given that interest rate. What is the optimal interest rate? He doesn't say – maybe because through the 30s the zero lower bound made that point moot.

Anyway, what actually happens at least much of the time – although, crucially, not when we're at the zero lower bound – is more or less the opposite: political tradeoffs determine taxes and spending, and monetary policy adjusts the interest rate to achieve full employment without inflation. Under those conditions budget deficits do crowd out private spending, because tax cuts or spending increases will lead to higher interest rates. And this means that there is no uniquely determined correct level of deficit spending; it's a choice that depends on how you value the tradeoff.

What about debt? A lot depends on whether the interest rate is higher or lower than the economy's sustainable growth rate. If rg you do have the possibility of a debt snowball: the higher the ratio of debt to GDP the faster, other things equal, that ratio will grow. And debt can't go to infinity –

it can't exceed total wealth, and in fact as debt gets ever higher people will demand ever-increasing returns to hold it. So at some point the government would be forced to run large enough primary (non-interest) surpluses to limit debt growth.

Now, Lerner basically acknowledges this point. But he assumes that the government always can and will run these surpluses as needed. He dismisses any concern about the incentive effects of high tax rates; certainly Very Serious People grossly exaggerate these effects, but they're not completely imaginary. And he says nothing at all about the political difficulty of achieving the required surpluses, yet such difficulties seem likely to be central if debt gets to very high levels.

A numerical example may help make the point. Imagine that one way or another we get up to debt equal to 300 percent of GDP, and that r-g = .015 – the interest rate is 1.5 percentage points above the growth rate. Then stabilizing the ratio of debt to GDP would require a primary surplus equal to 4.5 percent of GDP.

That's not impossible: Britain ran surpluses that big for several decades after Waterloo. But it's a lot to ask of a modern polity. Are we going to slash Medicare and Social Security? Are we going to impose a value-added tax, not to finance new programs, but simply to service the debt? It's possible, but you do have to wonder whether the temptation to engage in some form of financial repression/debt restructuring/inflation would prevail. And more to the point, investors would wonder about that, pushing r-g even higher.

The bottom line is that while functional finance has a lot going for it, it's not the kind of axiomatically true doctrine that Lerner – and, I think, modern MMTers – imagined it to be. Deficits and debt can matter, and not just because of the effects of deficit spending on aggregate demand.

That said, I don't think these objections are all that central to the budget issues facing progressives in the near future. You don't have to be a deficit scold or debt-worrier to believe that really big progressive programs will require major new revenue sources. But I'll explain that in my next post.