

functional finance

The term ‘functional finance’ was created by Abba Lerner to contrast with sound finance. It involves making decisions about the deficit and the money supply with regard to their functionality, not some abstract moralistic premise. While it seems to play no role in the dynamic stochastic general equilibrium model prevalent in macroeconomics today, it does play a potential role in a more complex model where heterogeneous agents with limited information interact in a model with many different aggregate equilibria. Yet Lerner’s functional finance theoretical model is far too simple to be acceptable, even as a rough guide for policy.

In the debate about how to pull economies out of the Great Depression, Abba Lerner created a steering wheel metaphor to contrast his ‘economics of control’ approach to policy with the then prevailing ‘laissez-faire’ policy. He argued that the laissez-faire approach was similar to driving a car without a steering wheel, the natural result of which was that the economy continually crashed, veering off the road first in one direction and then in another. It was time, he argued, for the government to adopt a Keynesian ‘economics of control’ approach in which the government used an explicit steering wheel – functional finance – to keep the economy running smoothly.

To complement that distinction between economics of control and laissez-faire, he contrasted the laissez-faire policy of sound finance with the economics-of-control policy of functional finance. Sound finance involved a set of rules – always balance the budget except in wartime, and do not increase the money supply at a rate greater than the growth rate of the economy. The problem, for Lerner (1944; 1951), was that these rules of sound finance were not analysed; they were simply accepted as being right. Lerner argued that, when governments understood how the macroeconomy actually operated, they would adopt an alternative ‘functional finance’ set of rules. Under the rules of functional finance, decisions about the deficit and the money supply would be made with regard to their functionality – their effect on the economy – and not with regard to some abstract moralistic premise that deficits, debt and expansionary monetary policy are inherently bad.

The rules of functional finance

Functional finance consists of the following three rules (Lerner, 1941).

1. The government shall maintain a reasonable level of demand at all times. If there is too little spending and, thus, excessive unemployment, the government shall reduce taxes or increase its own spending. If there is too much spending, the government shall prevent inflation by reducing its own expenditures or by increasing taxes.
2. By borrowing money when it wishes to raise the rate of interest, and by lending money or repaying debt when it wishes to lower the rate of interest, the government shall maintain that rate of interest that induces the optimum amount of investment.
3. If either of the first two rules conflicts with the principles of ‘sound finance’, balancing the budget, or limiting the national debt, so much the worse for these principles. The government press shall print any money that may be needed to carry out rules 1 and 2.

In proposing these rules of functional finance, Lerner's purpose was to shift thinking about government finance from principles of sound finance that make sense for individuals – such as running a balanced budget – to functional finance principles that make sense for the aggregate economy. Functional finance principles used the budget balance as a steering wheel: deficits increased economic activity, surpluses decreased economic activity. The budget balance had these effects because, in the Keynesian model, government spending and taxing decisions directly affected levels of economic activity. These effects had to be considered because, in the aggregate, the secondary effects of spending decisions and savings decisions, which Lerner and I (Colander, 1979) called macro externalities, had to be taken into account, whereas in individual decisions they did not.

Lerner's stark presentation of these rules of functional finance caused much stir in the 1940s and 1950s, when most Keynesians, including Keynes himself, were politically more circumspect about what came to be known as Keynesian ideas for government fiscal policy than they became in the 1960s (Colander and Landreth, 1996). Lerner's rules specifically ruled out worrying about the size of a country's budget deficit or national debt.

In the 1950s and 1960s, Lerner's functional finance rules became both the basis of most textbook presentations of Keynesian economics and the basis of textbook macroeconomic policy discussions. It became what was generally considered Keynesian policy. This could occur because Keynes's *General Theory* contained almost no discussion of policy; it did not mention fiscal policy, and yet there were strong political forces pushing for its use. Thus, when 'Keynesian policy' was attacked in the late 1960s and early 1970s, it was primarily the idea of Lerner's policy of functional finance that most people were attacking (see Colander, 1984, for a discussion).

That attack on 'Keynesian policy' intensified through the 1970s and 1980s, and by the 1990s textbook presentations of Keynesian policies had faded away. As they did so, so too did the concept of functional finance, and by the early 2000s few economists under the age of 50 had heard of it.

While the term 'functional finance' has disappeared from the macroeconomic textbooks, its influence continues among macro policy economists. The rhetoric of policy-oriented macro economists and their reaction to recessions is now quite different from what it was in pre-Keynesian times. When presenting fiscal policy to voters, governments are far less likely to talk about balanced budgets. Today, the potential benefits of government deficits in a recession are recognized. Similarly, policy-oriented macroeconomists discuss fiscal policy generally in terms of debt-carrying capacity such as represented by deficits as a percentage of GDP, not the need for a balanced budget, as was the case with sound finance. Even when a policy of functional finance is not used, the functional-finance role of fiscal policy is still seen as important since the expectation that government functional-finance policy will be adopted when crises occur can reassure agents and provide stability to the economy.

Why functional finance lost favour

Functional finance lost favour for a variety of reasons. First, Lerner's discussion of functional finance did not consider the politics of government finance; it assumed that the government could change taxes and spending according to the needs of the macroeconomy. In reality, both spending and taxing are difficult political issues, and the needs of politics generally trump the needs of stabilization. Second, the lags between recognition of a problem

and implementation of a policy were significant, and the policy would often go into effect long after the situation had changed. In Lerner's automobile metaphor, it was as if the steering wheel and the wheels were connected with a 30-second lag, and the windshield was opaque. Third, functional finance is built upon an assumption that the government knows what functional finance policy is best to follow – in inflationary times, increase taxes and decrease the money supply; in recessionary times, decrease taxes and increase the money supply. In the 1970s, when both inflation and recession occurred simultaneously, the functional finance rules seemed to give contradictory advice. These practical problems with implementing functional finance eliminated much, if not all, of the benefit of the steering wheel.

The reaction of Keynesian economists to the practical and informational problems was to limit the use of the deficit as a tool for fine-tuning the economy; the fiscal policy tool was a sledge, not a ball-peen hammer. The economics profession's reaction to stagflation was to accept a high rate of unemployment as the trigger for implementing an expansionary policy. Lerner did not follow the profession. His reaction to the stagflation problem was to argue that much inflation was not the result of excess demand but was instead what he called sellers' inflation. Sellers' inflation operated quite apart from demand pressures. Depending on how sellers' inflation was dealt with, there could be either high full employment or low full employment (Lerner, 1972).

Lerner saw sellers' inflation as so important that, beginning in the 1960s, he changed his research programme to centre on finding cures for sellers' inflation. He developed a market-based incomes policy in which property rights in prices are established, and individuals have to buy the right to change prices from others who change their price in the opposite direction (Lerner and Colander, 1980). Under a market-based incomes policy, rights in value-added prices would be tradable, so that any firm wanting to change its nominal price would have to make a trade with another firm that wanted to change its nominal price in the opposite direction. Thus, by law, the average price level would be constant, but relative prices would be free to change. With inflation controlled by such a plan, the rules of functional finance would once more become relevant (Colander, 1979). Politically, in the early 2000s such policies had little chance of even being considered by governments and had faded from economists' radar screen.

Macro theory and functional finance

It was not only the practical problems of functional finance that led to its demise. It was also that the profession essentially dropped the theoretical model upon which the concept was based. Functional finance was based on a coordination-failure model of macroeconomics – when individuals spent or saved, they did not take into account the effect of that decision on the aggregate level of spending; thus the economy needed some mechanism to internalize the spending complementarity and thereby determine the aggregate level of spending.

Today, among theoretical macroeconomists macro policy is thought of in a dynamic stochastic general equilibrium framework, and fiscal policy is discussed within an optimal taxation framework that assumes a representative agent is optimizing over a long-term horizon. The intuition behind such models is that the effect of any government deficit is mitigated by compensatory changes in the representative agent's spending decisions. This occurs because the agent will be responsible for paying off that deficit in the future.

In the now prevalent modern macroeconomic theoretical approach, the possible existence of macro externalities is essentially ruled since the representative individual is assumed to take all the indirect effects of spending into account.

Assessment of functional finance

So what should one make of functional finance? My view is that, theoretically, it remains important. The fact that much modern macroeconomic theory does not allow for the possible existence of macro externalities is, in my view, a problem of modern macro theory, not a problem with functional finance. The probability that the unique equilibrium, perfect rationality, perfect foresight, representative agent model underlying much of modern macroeconomics has much relevance to the real-world macro problems that we face is exceedingly small.

The macroeconomic theory problem seems more appropriately described as a coordination problem in which heterogeneous agents with limited information interact in a model in which many different aggregate equilibria are possible due to enormous strategic complementarities among agents. With multiple equilibria and coordination problems, there is no presumption of global optimality of the equilibrium chosen by the market. Everyone can know of the existence of a preferable equilibrium, but may not be able to achieve it by private actions. We can say something about that question only when we have a theory of equilibrium selection mechanisms. Currently we have none. Thus, in a multiple equilibrium economy with coordination failures, there should be no general presumption that the private economy, given its institutions, arrives at an equilibrium preferable to one achieved with government guidance.

That said, the functional finance theoretical model of Lerner is far too simple to be acceptable, even as a rough guide for policy. To say that individuals have limited information and do not fully take account of future effects of policy is not to say that they take no account of them. Private institutions develop which do precisely that, and any meaningful theoretical macro model must integrate such forward-looking private institutions into its structure. Doing so will involve highly complex models in which model selection by agents, agent interdependency, and social interaction by multiple agents are taken seriously. We are a long way from making such models tractable, so any formal macro model incorporating usable rules of functional finance is long in the future.

David Colander

See also

- < xref = xyyyyyy > budget deficits;
- < xref = C000399 > cost-push inflation;
- < xref = xyyyyyy > Keynesianism;
- < xref = xyyyyyy > multiple equilibria in macroeconomics.

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Index terms

budget deficits
coordination problems
functional finance
general equilibrium
Great Depression
incomes policy
inflation
Keynesianism
Lerner, A.
macroeconomic externalities
money supply
multiple equilibria in macroeconomics
national debt
optimal taxation
sound finance
stagflation

Index terms not found:

Keynesianism
macroeconomic externalities
multiple equilibria in macroeconomics