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 1998 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 Turgeon 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

is unsound. This principle of judging only by effects 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 function in an economy we may call Functional Finance. . . . Government should adjust its rate of expenditure and taxation such that total spending in the economy is neither 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, 'printing money,' etc. . . . then these things are neither good nor bad, they are simply the means to the desired ends of full employment and price stability.¹

These extremely simple ideas differ greatly from both the 'deficit hawk' and the 'deficit dove' views of budgetary policy. The deficit hawks argue that deficits cause inflation and high interest rates, that public spending 'crowds out' private spending, that the national debt will burden future generations – all in all, that deficit spending is virtually immoral. Deficit doves see problems in the views of hawks, finding little or no empirical support for their claims, and weakness, even confusions, in their theories. This particularly affects issues of the measurement of deficits and national debt, and also how we understand the impact of fiscal policy. But doves tend to agree that deficits are generally undesirable. By arguing that deficits are not really as big as they look, or that a larger economy can afford bigger deficits, they give too much credence to the views of the hawks, and nothing at all to Functional Finance.

Lerner was not alone among the New School's Graduate Faculty in promoting counter-cyclical fiscal policies to achieve full employment with price stability. Adolph Lowe, Hans Neisser, Gerhard Colm, Alfred Kaehler, and other New School economists advised President Roosevelt on policies combating unemployment. With a message that was not simply Keynesian, these graduates of the 'Kiel School' were perhaps described best as 'friendly critics' of Keynes. They were never completely comfortable with the framework offered in *The General Theory*, where Keynes considers neither technical change nor income distribution. Lowe, Neisser, and Kaehler all did important work on technological unemployment and the relation of technical change, income distribution and effective demand. Labor-displacing technical change, resulting in a shift in income distribution away from wages and towards profits, could result in a weakening of effective demand if capitalist propensities to consume are lower than those of workers. But the economists at Kiel in the late 1920s and 1930s, and at the New School's University in Exile (now the Graduate Faculty), in the 1930s and 1940s, admired Keynes's commitment to a policy-relevant economics focused on the business cycle and dedicated to eliminating unemployment.

1. From Lerner, Abba P. (1943), 'Functional finance and the federal debt', *Social Research*, 10, February, pp. 38–51.

But Keynes's economics was not developed in the direction supported by Lerner and his colleagues. Instead, the profession applied its developing tool box to grounding Keynes's macro in neoclassical microfoundations. The 'Grand Neo-Classical Keynesian Synthesis' – as Samuelson first dubbed these efforts that would later become known simply as 'the neoclassical synthesis' – sought to reconcile the rational maximizing agents of neoclassical theory with *some* of Keynes's insights. The real balance-effects arguments of Patinkin and his peers dealt with aggregate variables, included money in the analysis, recognized the multiplier and even acknowledged liquidity preference while still maintaining a picture of market economies as eliminating unemployment through the price mechanism. By insisting on the validity of the price mechanism, however, even if only in theory, they sacrificed what for many was the overarching theme of Keynes's contributions – the paradoxical nature of macroeconomics. Lerner called it 'topsy-turvy' economics. When the economy reaches equilibrium, or at any rate a steady position, in which there is still involuntary unemployment, then saving, labor-saving technical progress and imports all will *reduce* the performance of the economy and increase social costs. However when the economy comes to equilibrium only at full employment, these aspects all improve the economy's performance and are socially beneficial!

The important point is that we do live in a topsy-turvy world, not in a world of rational choices and smooth equilibrium. So deficits may be helpful and surpluses dangerous, saving may slow us down and technical progress can make us poorer. It is not, however, a matter of 'realistic assumptions.' All theorizing has to abstract and simplify. The point is to identify and understand the actual mechanisms and market forces that govern our economic relationships. Then we can devise policies to adjust these mechanisms and forces, to make them work better and put the topsy-turvy arrangements right side up. That was not only Lerner's program, it was also that of the New School, and it still is today, as the contributions of this conference show.

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