

Are modern monetary theory's lies “plausible lies”?

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“It's the art of statesmanship to tell lies but they must be ‘plausible lies’” –
J.M. Keynes.

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MMT has done what few heterodox economic theories have done; it has become part of the mainstream conversation. It is talked about by pundits and politicians, which means that standard macro economists have felt compelled to respond to its arguments. That's an enormous accomplishment that will, I hope, lead to improvements in macroeconomic theory and policy. Its creators deserve to be congratulated. But I am not too hopeful. MMT is more of a marketing success than an intellectual success that has caused standard economists to rethink their theory or policy views, and I suspect that, once MMT's political usefulness to progressive politicians diminishes, standard economists will push MMT back into the heterodox wilderness, and settle back into their unwarranted complacency.

Since MMT is not a precisely spelled out formal theory, but more a narrative about the nature and development of money and government finance, let me start by summarizing how my interpretation of it used in this article. What I mean by MMT are the set of shared ideas about monetary and fiscal policy attributed to economists such as Randall Wray (2014) and Stephanie Kelton (2001). The ideas that I will focus my discussion on can be summarized in three distinct and separable propositions.

- Idea 1: The way to understand the role of money in the economy is to think of money first as credit – money is an abstract accounting system of interpersonal obligations. Physical money plays only a secondary role in that accounting system. MMT holds that in the historical development of money, abstract money credit preceded the development of physical money rather than physical money preceding credit, as it does in most standard histories of money.
- Idea 2: Government spending, taxing, and monetary policy should be thought of in Abba Lerner's functional finance framework, in which the policies are judged by their effects on the economy, rather than in a sound finance framework in which government faces a budget constraint, and taxes (either current or future with bond finance) are thought of as paying for government spending.
- Idea 3: The above two ideas are a useful guide to real world U. S. policy thinking. They emphasize that economist's focus on the need for balanced budgets is misguided and that the supposed financing constraints that require government to pay for new programs with taxes or debt are largely illusory.¹

I largely agree with the first two but largely disagree with the third.

¹ In their more theoretical discussions, they do a reasonable job of explaining the assumptions on which these conclusions are based, but when they allow politicians to use MMT as justification for arguments without the caveats, they allow MMT to be associated with those policy ideas.

MMT's story of money

As a descriptive narrative theory of money, MMT does a much better job than the standard textbook economic narrative in conveying a sense of the development of money and the role that money and credit play in our economy. Its ideas, in my view, are not especially heterodox, and are consistent with the broad-based historical macroeconomic monetary cannon as captured in the work of monetary economists such as Thornton, Bagehot, Keynes, Yeager, and Goodhart.² That said, I agree that standard modern economists, because of their formal modeling obsession, have lost sight of the broader narratives that necessarily accompany a model, and determine how the model is interpreted.

A central MMT complaint about standard monetary theory is that standard economics doesn't tell a good story about the introduction of money into the economy. In the standard story, money is central to exchange; physical money makes markets possible. In the MMT story, physical money is simply part of a broader accounting system in which credit plays a central role in making markets possible. Thus, according to MMT advocates, money is inherently involved with credit, and in much of their writing, following Georg Knapp (1924) and Abba Lerner (1947), they treat money as inherently involved with state credit.

I find credit theories of money satisfying and insightful. They offer a conception of money that better fits my sense of money as a complex social convention that is more deeply entangled with the real economy than the standard conceptions of money allow. In my view the most likely reason it hasn't been adopted by the profession is because recognizing this aspect of money undermines standard economist's belief in the usefulness of formal mathematical models of a monetary economy as a direct policy guide. It is precisely that entanglement that makes money not fit into formal theories – money's very essence is connected to the social contract that holds society together. Technical models only provide general background guidance, not direct policy guidance. In a monetary economy real world policy guidance does not follow from technical economic models, but rather from models which have social relationships embedded in them, or which are somehow modified to take social contract issues into account.

Money as a creature of the society

While I agree with the credit theory of monies, I interpret the underlying theory slightly differently than do most MMT advocates. Whereas they emphasize Georg Knapp's view that portrays money as a creature of the state, I emphasize the views of Henry Macleod (1889), which sees money as a creature of society, rather than just as a creature of the state.³ Money involves credit, but it need not be state credit. The analysis of money is, in principle, separable from the analysis of government finance, and connecting the two can lead to misleading policy implications.

² As its advocates make clear, MMT is not a new theory; they are reviving earlier credit theories of money by economics such as Georg Knapp. MMT is grounded in earlier economic ideas that have, to varying degrees, been accepted by broad-based mainstream economists, such as Charles Goodhart. So, while MMT provides a much richer monetary theory than can be found in economists' formal standard models, I don't see MMT so much as a paradigm shift, but rather as a welcome refocusing within the broad-based mainstream of a narrative that has been almost forgotten by technically focused IS/LM and DSGE macroeconomists.

³ Neil Skaggs (1998) has emphasized the importance Macleod's work and has expanded on Macleod's credit theory of money. Randy Wray's theoretical discussions of MMT foundations of money are often nuanced, and, in some of his work he specifically references Geoffrey Ingham and David Graeber who go beyond the state theory of money.

The essence of credit theories of money involves seeing relations and trust among people as central to any theory of money. Money is best understood as part of an accounting system under which individuals keep track of their socially determined obligations to others. Goods can be traded for other goods without physical money as long as the individuals share an accounting system. The accounting system provides the foundation for the stability of society, and can be thought of as important part of its underlying operating system.

In pre-capitalist traditional societies, most obligations were not monetized, but were built into the fabric of society so little monetary exchange was needed. For example, serfs were allowed to use the land of the noble but in turn had to provide the noble with a portion of the harvest. These obligations were known and did not need any exchange of a physical money. Similarly, if someone wanted to borrow a cup of sugar with the expectation that the favor would be returned, the agents could simply keep the background accounting in their mind. Taxes were monetized and are the part of this system of obligations that MMT advocates focus on in their story of the development of money. According to MMT advocates by allowing debt of the state to be used in the payment of taxes the government created accounting money. It follows that money is a creature of the state.

My alternative spin on this history is that while that may be historically what happened, the state is not necessarily involved with the essence of money. Any large agent with outstanding debt, for example the church, who was willing to accept payment of that debt in fulfillment of an obligation to it, could have created an alternative credit money. Money is a creature of society, not of the state. Accounting systems involve much more than just government, and, in my view, evolved from the bottom up along the lines proposed by Martin Shubik (Shubik and Smith, 2016), not from the state down. So, within this broader “money as a creature of society” narrative, one thinks of a society as a set of obligations that is held together by explicit and implicit accounting systems that keep track of, and balance, the obligations of the agents to one another and to collective organizations that comprise society.

As Marx pointed out, capitalist market economies changed the nature of social relationships and they did so by changing the accounting system, and making it less focused on a set of in-kind obligations and more focused on obligations measured in monetary values. This was accomplished by formalizing the accounting system with technical advances such as double entry bookkeeping. These advances allowed the trading and complexification of these obligations.⁴ Again, these trades could be done without the exchange of physical money – within an accounting system, when you receive something from somebody, or take on an obligation, you can pay for it by debiting your account. No physical money need change hands for the trade to take place – the accounting system takes care of it all. MMT argues that the important aspects of money developed from the accounting systems and that physical money, such as gold, was simply the physical representation of an abstract accounting credit. It follows that it is the trust in the accounting system, not the inherent properties of the physical money, that gives money its value.

⁴ Money makes material relations central. Other accounting systems are possible. For example, in the Middle Ages, the church had an accounting system – and people earned credits toward entrance to heaven by following church doctrines. Since the value of eternal salvation overwhelmed material goods what might be called spiritual accounting dominated material accounting. Once the church started selling indulgences, the accounting system changed, allowing material relationships to expand in importance since one could buy entrance to heaven.

The development and role of physical money

An informal accounting system had severe limitations for both large and small items. For large items it needed to be formalized, which it was with various advances in bookkeeping and accounting. It was such developments that allowed capitalism to develop. For small items, tracking transactions in ledgers was cumbersome, and thus a simplification was developed. Societies created a physical representation of abstract credits or debits. What most people think of as money – cash – can be understood as an accounting simplification. Rather than keeping the credits and debits in a ledger, the accounting system was modified so that it had an analog computational system that eliminated the need to keep precise accounting records in the ledgers. To do that, it created a physical manifestation of a credit – say a dollar bill, a cigarette, or an ounce of gold. These could be transferred or held as stores of value. When that physical manifestation was transferred from one to another in payment for a good or fulfillment of an obligation, it was the equivalent to a debit and credit entry on the books of the buyer and seller. When paying with cash, the accounting ledgers are automatically adjusted through the holding of cash, not through any entries on the ledgers. Thus, the development of a physical money allowed a reduction of accounting costs.⁵ So what we think of as cash is best thought as “analog accounting money”.

I went through this historical discussion to emphasize that thinking of money as credit and part of the accounting system is not just a minor change to economists’ narrative. It means that the standard formal macro models that assume an exogenous demand for money, or that treat money as a commodity, aren’t capturing the central role of money in the economy. In the credit theory of money the monetary accounting system is seen as part of the underlying superstructure of the economy, and thus, it requires trusting that whomever oversees that monetary accounting system will not take advantage of their control of that accounting system to benefit themselves or their friends. If people lose faith in the fairness of that monetary system, they lose faith in the economy, and the economy will break down.

Separating monetary policy from government spending policy

MMT’s emphasis of the connection between money and state credit allows it to draw policy implications about government finance. I see the connection as misleading. In creating a system in which people have trust in the monetary system, they may well design the system to keep these state financing issues and monetary system issues separate, not because the issues have to be separate, but because in order to get the social contract agreed to, they were chosen to be kept separate. This separation is part of the operating system providing trust in the monetary system. The monetary authority is restricted from paying for government goods by direct bank financing because the temptation to do so is seen as too enticing for a government to resist, and its use as a direct financing method would decrease the needed trust in the monetary system.

Not making a connection between money and state credit, but rather making the connection to general societal credit not limited to the state, also allows MMT’s insights to be better used in guiding our thinking about private monies of the future. Such monies are on the horizon because of computational advances in information processing and backroom accounting. Digital monies are exponentially increasing in importance, and it is likely that accounting for

⁵ My interpretation of the MMT argument against other histories of money is that they get the focus wrong. They give far too much focus to this “analog accounting money” and too little to the accounting system of which it was a part.

purchases can be automated at close to zero marginal cost. This means that the real-world monetary system is becoming more like the theoretical accounting system underlying the credit theory of money. Specifically, with the developments of digital monies, private cryptocurrencies, and blockchain ledger accounting, private firms, such as Facebook's Libra, will likely challenge state control of aspects of money in the future.⁶ Since there are large rents to be made in the seignorage associated with issuance of money, governments need economist's guidance on how these new private monies should be dealt with, and MMT offers important insights into these issues.

Our current monetary system will be further challenged by the ongoing globalization of the world economy in which multiple currencies are used. As international clearing systems become automated, we can expect disruptions in multi-currency transactions technology. In a globalized economy, with advanced computational and information processing tools, we can expect competition among state and private monies and units of account in ways that we have not seen before. MMT's narrative about money as credit can help us better understand these developments and can help guide the design of policy to prevent private capture of the rents and seignorage that will accompany those changes. Unfortunately, currently MMT is not being used to analyze such problems. Instead, by connecting money only to the state, MMT suggests that it has no insight into these private money developments.

MMT and functional finance

A second MMT idea is that the functional finance ideas of Abba Lerner should be given more focus in thinking about policy. I fully agree that, if one is talking about stabilization theory, functional finance provides important theoretical insights into the technical theory of how government finance affects aggregate spending. But, as is the case with the credit theory of money, they are insights that the best of standard macroeconomists have already incorporated into their economic thinking about policy. While economists (Keynes included) found functional finance strange when Lerner first presented it in the 1940s they quickly came around to accept its logic in guiding thinking about the theoretical usefulness of countercyclical policy. As they did so the important insights of functional finance become part of the standard broad-based economic cannon.

Where I have problems with MMT's focus on functional finance is when it is extended to real-world government monetary and fiscal policy. One reason this is problematic is because there is nothing in Lerner's insights about the need for government stabilization policy that require the stabilization to take place by deficit financing. To see this let us consider Lerner's implicit model, which is a highly simplified optimal control theory model of an economy with spending coordination failures. Specifically, in the model agent's individual decisions about spending affect aggregate spending, but agents don't take that effect on aggregate spending into account in their individual decision to spend. Optimally, they would take it into account. This means that in Lerner's model aggregate spending can be too high or too low, and a policy requiring all agents to take it into account is needed.

⁶ The US is unlikely to see these changes soon, but most countries having fewer financing options than does the US government, will.

An alternative to fiscal policy stabilization

By connecting Lerner's policy for dampening spending fluctuations to government spending policy, and suggesting it had relevance for the real-world policy, Lerner reduced some of functional finance's theoretical usefulness. The best way to see this is to recognize that fiscal and monetary policies are not the only policies that could achieve stabilization. In theory, the same aggregate results could have been achieved without using fiscal policy at all. Moreover, within Lerner's implicit model fiscal policy would not even be the optimal way to deal with these fluctuations if one accepted standard economic cost benefit analysis. The problem is that functional finance places the entire onus of adjusting spending on the government, when in Lerner's model it would be more efficient if the spending adjustment were distributed widely among all agents so that those with the lowest cost of adjusting their spending were incentivized to do the adjustment.

Such a general policy solution could be achieved with what might be called a "functional spending policy" rather than a functional finance policy. A functional spending policy would involve government passing a law requiring all agents in the economy to coordinate their spending decisions in a way that led to the desirable level of aggregate spending. Specifically, say the government determined that aggregate spending was too low. Each agent would be required to increase their spending levels by his share of the needed adjustment, or alternatively to pay someone else to increase their spending by the shortfall. For example, if actual output was 5% below desired output, an individual whose spending base was \$4,000 last period might be required to spend \$4,200 this period. If that agent continued to spend \$4,000 he would be required to buy \$200 of spending certificates from someone who spent \$200 more than his spending base.

The price of those spending certificates could be positive or negative, depending on the supply and demand for spending above or below the desired spending level. If desired spending equaled actual spending in the absence of the program, then, with the program, the price of these spending certificates would be zero. If aggregate spending were "too high" the price of spending certificates would be positive, and agents would be discouraged from spending. For example, an agent with \$200 more in spending than his base might buy a \$200 spending certificate for \$4 from an agent who was \$200 below his base. If aggregate spending was "too low" then the price of spending certificates would be negative, and people would be encouraged to spend. Assuming all the usual wild assumptions about markets working, this "functional spending solution" would keep spending at its ideal level by spreading the adjustment to all actors in the economy, rather than have government do all the adjustment through its fiscal policies.

I am not arguing that such a "solution" makes real-world policy sense. But the reasons it may not make sense are practical and social, not theoretical. The implicit models underlying it are mechanical, real world markets and policy are organic and evolving. Mechanical solutions do not easily translate to organic realities. They might be relevant but, to make that decision requires detailed institutional knowledge of the organic reality, that goes far beyond theoretical understanding. At best, technical economic theory provides some background insights that actual policy makers should take into account. It does not provide direct policy guidance.

It follows that one can hold the position that functional finance provides important theoretical insights (a position I hold), but as an actual real-world policy is highly limited in its usefulness (a position I also hold) The reason is that functional finance, like the above described functional spending policy, has serious practical problems of implementation.

I am also not arguing that the distributional effects of this spending certificate market policy are preferable to the distributional effects of an increase in government spending. Functional finance abstracts from such distributional issues. My point is that the real-world policy makers debate about fiscal policy is generally less concerned with aggregate spending, which is the focus of functional finance, and more about the distribution of spending, which is not the focus of functional finance. For example, functional finance is neutral on whether an expansion in aggregate spending is generated by increased government spending or by decreased taxes. If aggregate spending is considered too low, there is no functional finance reason why it can't be increased by cutting taxes. If MMT's theoretical insights had been presented as a justification for cutting taxes, rather than as a method for paying for new programs, I suspect that progressives would have been far less supportive of it, while supply siders would sign on.

Good fiscal policy should be both sound and functional

The above discussions of MMT's credit theory of money and functional finance ideas, while critical, are generally supportive of MMT. It is when one moves to MMT's implications for real-world policy where I have my strongest disagreements with MMT advocates. In my view MMT's usefulness, like almost all of economic theory's usefulness, is in providing abstract theoretical insights into policy design and theoretical modeling of the economy, not in providing useful advice directly applicable for policy.⁷ The reason why is that the technical models cannot be easily translated into the real world. The theoretical insights are overwhelmed by political and institutional forces. Economist's formal models are mechanistic; real-world events are organic.

Consider functional finance; it assumes a well-functioning government exists whose goal is to maximize a known and shared social welfare function. It assumes that government can easily change its spending and taxing policies, and that the only negative consequence of government deficits, or of expansionary monetary policy, is inflation as measured by the CPI. That's not the real world I know. The real world I know has a government that is dysfunctional in many ways. Control of this government fluctuates among competing groups, who have different visions of the goals of economic policy. The decisions of whomever is currently in control are often governed by political considerations and involve significant private rent seeking that has little to do with the common good. Policies designed to be implemented by a beneficent well-functioning government are unlikely to work in the real world where politics, not economic theory, drive policy.

⁷ Let me be clear. MMT is not alone in this unacceptable blending of theory and policy. It is a central characteristic of modern standard economics which has lost its methodological bearings (Colander and Freedman, 2019). My position is that as a practical matter the two can't be blended, and as Nassau Senior, the first Classical economist to discuss economic methodology, argued long ago a theoretical economists' "conclusions, whatever be their generality and their truth, do not authorize him in adding a single syllable of advice. That privilege belongs to the writer or the statesman who has considered all the causes which may promote or impede the general welfare of those whom he addresses, not to the theorist who has considered only one." (Senior, 1836)

Functional finance tells us that technically, in a model in which government can easily enact policy, and can easily change spending and taxes, assuming we do not have inflation, that there is no need to worry about government deficits; we should print money to finance new socially beneficial government programs. But is it realistic in the real world?

On the basis of such a model, does one really want to advise our real-world government that it doesn't have to worry about paying for its new programs? If progressives do not need to worry about paying for spending, then a similar argument exists for Tea Party advocates who want to lower taxes. So, if MMT insights on credit money and functional finance are easily translated into real world policy, why not just lower taxes to zero and have government spend on whatever the party in power wants?

The other MMT insight--the credit theory of money--suggests that policy advice should come from a much more nuanced model. Its insight is that money is part of the foundation of the economy, and that money is based on trust. In our politically divisive times, trust in government is hard to come by. An important goal of any policy should be to encourage people to trust the government and believe that it will make reasonable decisions on spending and taxes. What effect various policies will have on trust is not something that economists have any expertise in. I interpret the Classical prescription for sound finance as reflecting judgements about these trust issues, not about technical economic models. Sound finance policy and restrictions on financing spending by monetary expansion force groups with competing visions of appropriate policy to compromise and find a middle way.

Thus, I interpret sound finance and sound money policies not as theoretically determined policies, but rather as politically determined compromise policies that provide checks and balances on the way government power is used. Balancing the budget, limiting government debt and restricting monetary expansion, can be understood as guidelines that would have been integrated into a social contract that implicitly developed among various competing groups. MMT tells us that institutional trust is important, and it seems reasonable that some such restrictions are integrated into the monetary accounting system that MMT's credit theories of money highlight. They are not rules that follow from economic theory; rather, they are rules that evolved to govern the competition of competing political interests. Those rules seem limiting to those in power. But, by accepting limits on their spending when they are in power, the tradeoff is that they get limits on the other side when they are out of power.

Judgements about "sound finance" can, and should, change over time as problems and institutions change. That's what makes policy so complex. When "sound finance" was interpreted as meaning fixed precepts that could never to be broken, it provided lousy policy guidance. But when it was interpreted as providing flexible precepts capturing important real-world political and psychological realities that are useful to be kept in the back of policy maker's minds, sound finance provides useful guidance. Good fiscal policy is both sound and functional.

Conclusion

The clash between considering the theoretical model results and the real-world results can be seen in the interaction between Lerner and Keynes. While a graduate student at LSE Lerner travelled to Cambridge to convince Keynes that his general theory was wrong. But while there, Lerner was converted and became an early interpreter of what Keynesian economics

meant. He wrote important interpretive articles as well as a book, *Economics of Control*, (1944) that spelled out the theoretical outlines of what we now consider Keynesian stabilization policy. It is Lerner's conception of Keynesian economics that most influenced the textbook model. But Lerner's model did not capture Keynesian subtlety. Whereas Keynes was circumspect and nuanced about the policy implications of his model, Lerner was not – he pushed the model to the limit, and if the model said it, then it was the policy to follow. That's great for teaching models, but it does not provide good policy guidance. Keynes was both a statesman and a theorist; he recognized the difference between policy following from a model and policy following from a full consideration of all issues. So, my suggestion is that in their policy advocacy, MMT advocates should become more like Keynes, and less like Lerner.

An encounter between Lerner and Keynes captures the difference between theoretical understanding of an issue and the policy understanding of that same issue, and provides insight into my disagreement with MMT advocates about policy. At a Fed Seminar that Keynes gave, Lerner made an impassioned argument for functional finance policy, arguing that deficits and debt don't matter. Much to the surprise of Keynesians who were there, Keynes lambasted Lerner for failing to understand the policy implications of his theory. The incident is likely the one that some have cited as the time when Keynes stated that he was not a Keynesian (Colander, 1984).

Later that evening, according to Alvin Hansen, they were at dinner and Abba Lerner came up to Keynes and asked him "Mr. Keynes, why don't we forget all this business of fiscal policy, public debt and all those things, and have some printing presses." Keynes, after he looked around the room to see that no newspaper reporters could hear, replied "It's the art of statesmanship to tell lies but they must be "plausible lies." (Colander and Landreth 1996). Once you enter the realm of plausible lies, you are in the realm of real-world policy. MMT's argument that economic theory tells us that progressive politicians don't have to worry about how to finance new spending doesn't meet that 'plausible lies' criteria.

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