Funding the Future

The writers of Labour's 'fiscal rule' are opposed to mo...

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I mentioned yesterday that James Meadway, who is John McDonnell's chief economic adviser, had dismissed modern monetary theory out of hand at the weekend, in the process committing Labour to the austerity agenda which, right now, is pretty much the only known alternative in town.

I was amused, and not surprised, to note that Jonathan Portes waded into the debate on Twitter, saying in response to a tweet that circulated my work to a number of well-known economists:

So, the people (Jonathan Portes and Simon Wren-Lewis) who wrote Labour's fiscal rule that promises balanced current budgets and borrowing only within the constraints of the market (however pro-cyclical that constraint may be, most especially given their vehement dedication to central bank independence), and so guaranteed that Labour will remain committed to the austerity policies that George Osborne and Philip Hammond have been noted for, are also committed to denying that the state may use the very obvious power it has to create money for any purpose bar bailing out banks, as most quantitative easing did.

Just to make sure we know what we're talking about this is Labour's Fiscal Credibility Rule, written by Jonathan Portes and Simon Wren-Lewis and adopted by John McDonnell:

Candidly, it's hard to differentiate this from anything produced in the Brown / Balls era. It is pure neoclassical economic thinking. I think that suggestion, much discussed Simon Wren-Lewis on Twitter yesterday, simply to dismiss the suggestion from someone not familiar with economics that it was neoliberal, needs to be explored.

First, to pick a theme from the blog post of Simon's that Jonathan Portes highlighted, the macroeconomics on which this 'rule' is based has its roots in microeconomics. As

Simon has accepted, this is in many ways the difference between neoclassical and MMT economic thinking. But the difference is not minor. The microeconomics referred to makes some pretty major, and almost invariably incorrect, assumptions. I am, of course, aware that these are relaxed on occasions, but the fundamentals remain in the macroeconomics based upon it. In particular, there is an assumption that markets can allocate resources efficiently. And that when doing so they eventually use all available resources, even if it takes time for them to correct to external shocks so that resources are used in this way, with full employment being re-established, as the norm. The model, then, assumes government ultimately need not intervene in markets to create this outcome. Unsurprisingly, as a result, the modelling suggests that there is no reason for the government to run a deficit on day-to-day spending because the markets can be relied upon to sort things out. That there is no evidence to support this assumption is apparently beside the point for Jonathan; that's what the model says (even if that's the inevitable outcome of the assumptions made and not the consequence of any observed reality) and so that is what the rule must say as well.

There are also major problems with the macroeconomics based upon these assumptions. In particular, taxation does not play a proper role within it, and nor, come to that, does money. That is because money is simply assumed to transfer value, as does much of tax, but given that we know that is not true of finance, and that taxation plays a much broader role within the economy than this, this macroeconomics is inappropriate as a basis for determining any fiscal rule, for which it can have no answers. Again, then, this model is inappropriate for the task it is being asked to do: it does not address questions of fiscal balance but does instead assume them away, just as this fiscal rule does.

Thereafter the microeconomic assumptions underpinning this macro gets what it says about money wrong. As the Bank of England had to say in 2014:

The reference to 'some' economics textbooks might, appropriately, be read as referring to the vast majority of neoclassical textbooks.

This means it is not true that, as Simon claimed, that the main difference between neoclassical theory and MMT was that the former relies upon monetary policy to control inflation and the latter of lies upon fiscal policy to do so, although that is undoubtedly true, and it so happens that because monetary policy is dead in the water only one of the two can now work. Instead, the real difference is much more fundamental.

Most especially, the differences come at three levels. First, MMT looks at the world from a macro perspective, not a micro one. In other words, it is macroeconomics. That might make it fit for the purpose of managing the macroeconomy.

Second, MMT ascribes appropriate functions to tax and money that actually recognise the way in which they really do play a role in the economy, and which, in the case of money fits with the Bank of England's description, noted above.

And third, MMT does not assume that the market economy automatically uses all resources available within the country, and nor does it assume that the market delivers economic balance at full employment. Given that these assumptions reflect reality, unsurprisingly it suggests a somewhat different approach to macroeconomics to a model based upon inappropriate macroeconomic assumptions. In particular, it presumes that the state might have a role in creating full employment, and might need to spend to achieve that purpose, and what is more it appreciates that in the process all that it is doing is creating the capacity to pay any necessary tax to control inflation, which is a desirable objective of macroeconomic policy, but one that is not nearly as important as delivering sustainable well-being for those who wish to work, and those they wish to support, within a country.

Jonathan Portes might be with James Meadway in rubbishing MMT then. I'm willing to believe that what he says is true in this regard. But what it also means is that he is willing to promote macroeconomics that is based on inappropriate assumptions and models, that cannot say anything useful on fiscal balance because it is assumed that there is nothing to say, and makes balancing the government's books more important than any other economic priority. I'd suggest that's getting most things wrong, from the basics to the assumptions to the objectives to the policy prescriptions. But no doubt Jonathan Portes will handle the criticism by dismissing me as he did his co-author Howard Reed, which I am sure he was chuffed about.