Economics 1936, Keynes
Problem Set 7. Functional finance as a framework for a theory of the composition of aggregate demand.
Due Monday, November 15, 11.59 pm

Functional finance views the government budget primarily as a means of achieving full employment, but Abba Lerner, who first laid out the theory of fiscal policy implicit in *The General Theory*, also wrote

> Equality of the marginal social benefits from the different directions of permissible spending is a necessary condition for the optimum use of the resources that can be employed. (*The Economics of Control*, p 316)

That is, the government budget and accompanying monetary policy is a means of achieving the most desirable division of aggregate demand between private consumption, private investment, and government economic activity.

1. **Why might optimizing the mix of aggregate demand lead to a permanent budget deficit at full employment? In other words, why might sound finance—interpreted as a requirement of balancing the government budget at full employment—make it impossible to fulfill the functional-finance goal of optimizing the mix of aggregate demand?**
2. **Once we accept the premises and logic of functional finance and reject the doctrine of sound finance, why do taxes exist at all?**
3. **Explain why, even if the government budget is perpetually in deficit, the national debt need not grow relative to the size of GDP.**
4. ***Raising Keynes* takes issue with the mainstream view that deficits necessarily crowd out investment even if the Debt:GDP ratio is stable. What is the basis of this disagreement?**