Health Care Reform, Universal Coverage and Financial "Basics"

A Functional Finance Perspective

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A Developing Consensus toward a Health Care Reform

Today, Americans pay for their health care in a number of different ways. They finance it through skyrocketing out-of-pocket expenditures on health insurance premiums, deductibles, co-payments, and co-insurance; through the uninsured paying directly for care; through federal, state and local taxes; through increased expenditures on goods and services as businesses pass their health care expenses onto prices; through reduced real wages and declining non-medical benefits that employers implement via a wage-benefits trade-off (Angell, 2003, p. 2). However, the recent escalation in the costs of health care has made it more difficult for employers to pass the costs of increasing premiums onto their workers. Not so long ago, the average annual cost of an employee family plan was $5,000. Back then, a 10 percent annual increase in premiums "meant that the employer had to reduce the rest of total compensation by $500", something that "could be done relatively easily" by increasing nominal wages *less* than would be required for a full inflation-adjustment, *or* by keeping the *nominal* wages constant, thus reducing the *real* compensation of an employee (Enthoven and Fuchs, 2006, p. 1546). But health care costs have risen so much that, today, a 10 percent increase in premiums adds an additional $1,000-$2,000 to employer's costs (depending on location and generosity of health care benefits). Passing these costs on to low- and middle-income workers "requires a cut in the *nominal* wage, which workers fiercely resist. The alternatives are only slightly more palatable: an increase in the employee's premium contribution, a larger deductible, or a higher copayment" (ibid., 2006, p. 1546). Further, as a result of increasing premium contributions, growing deductibles, co-payments, co-insurance, and widening gaps in coverage, etc., employee take-up rates for employment-based insurance have been declining. Given this shrinking enrollment pie, insurance companies have tried to realize more profit per enrollee – a "strategy that further exacerbates the affordability

crisis and is difficult to defend" (Schaeffer, 2007, p. 1557). In this "context of decreasing affordability for employers and employees", there is a broad concern that employment-based insurance is no longer viable (Ginsburg, 2008, p. 675).

Moreover, physicians and hospital administrators are getting "fed up with the present chaotic and costly system of health care financing" associated with a multitude of health care plans and insurance companies that they have to work with on a daily basis (Fuchs, 2007, p. 1544). This multiplicity of insurers forces health care delivery institutions to spend enormous amounts of human and financial resources on administration and billing (more than twice as much as in Canada). Besides, they have to maintain "expensive cost-accounting systems to attribute costs and charges to individual patients and payers" (The Physician's Working Group, 2003. p. 799). In addition, health care provider institutions hire armies of business consultants, brokers, coding software vendors, and other satellite businesses to help them organize and manage the multi-payer health care system (ibid., 2007, p. 799)[1]. As Fuchs (2007) remarked, there may finally come a time when most physicians and hospital administrators will admit that: "There must be a better way to pay for health care" (Fuchs, 2007, p. 1544). In fact, 15,000 reform-minded physicians, health care professionals and medical students have already joined a prominent organization committed to a *single-payer* health care system. Realizing the inevitability of a major health care reform over the long-run, Physicians for a National Health Program (PNHP) have developed comprehensive proposals for the design and financing methods of a universal, comprehensive, single-payer health care system in the U.S.

[1] These administrative expenses associated with a multi-payer health care system consume about one third of the nation's health care bill (Angell, 2003; Hsiao, 2007).

The General Architecture of the PNHP's Proposal for Universal Coverage

As advocated by PNHP, a single-payer, non-for-profit, universal, comprehensive health care system would rely on a *single* public agency that would organize health care financing. At the same time, the delivery of health care would remain largely *private*, and patients would exercise a free choice of a provider or a health care facility. Note that such a system does *not* amount to "socialized medicine". The latter implies government *ownership* of health care delivery institutions. Rather, the universal health care system of the PNHP-type should be properly called as "social *insurance*" because the government's role would be that of a *payer* rather than an *owner* and an executive (Bodenheimer, 2005, p. 1431).

As proposed by PNHP, to simplify hospital administration and virtually eliminate billing (that currently consume almost one third of the nation's health care bill), health care delivery institutions could choose to operate on a global budget received from the government health care agency[2]. To eradicate the current practice of shifting the costs of capital expenditures onto the health care bills, such budgets would be used *solely* for *operating* expenses. All *capital* expenditures would be financed by the public health care agency. Because health care delivery institutions would be proscribed from the current practice of allocating their operating budgets for capital expansion, profit, excessive executive compensations, marketing, etc., a single-payer global budgeting system would "shift the focus of hospital administration away from lucrative services that enhance the "bottom line" and toward providing optimal clinical services in accord with patients' needs" (PNHP, 2003, p. 800). Salaried practitioners would be completely insulated from the financial consequences of their clinical decisions, allowing them to focus on the provision of the best possible care in accordance with their patients' needs (ibid., 2003, p. 800).

[2] Such budgets would be renegotiated on an annual basis, based on past financial and clinical performance, projected changes in the levels of services, wages and input costs, proposed new programs, etc. (PNHP, 2003, p. 800).

Alternatively, health care delivery institutions could choose to operate on a fee-for-service basis. To simplify administration and billing, such fees would be billed to the public health care agency via a simple, computer-based system, according to a negotiated formulary (ibid. 2003, p. 800). Clearly, a fee-for-service system carries a potential to be abused, leading to health care spending inflation. From this perspective, global budgeting is a better way to organize health care financing. Nevertheless, the experience of Western countries with universal single-payer systems shows that there are effective ways to curb the inflationary potential of a fee-for-service system of health care financing (ibid., 2003, p. 800). .

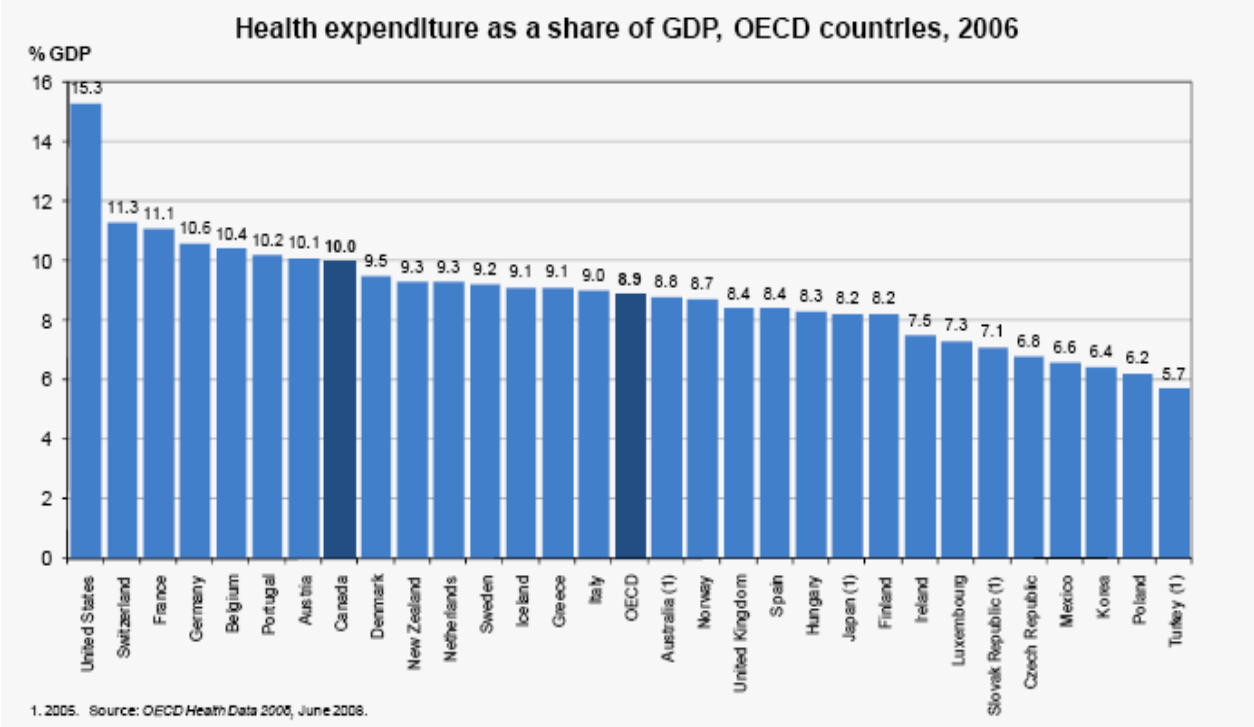
Clearly, a universal, comprehensive single-payer health care system would eliminate patient billing, premium contributions, deductibles, co-payments, and co-insurance, etc. Covering every American for all medically necessary services, this system would make health care a *right* enjoyed by *all* citizens in *all* developed countries.

The PNHP's Response to the 'Money Problem'

In the context of a health care reform debate, it is commonly argued that "*the problem* with this developing consensus for universal coverage *is money*" (Lemieux, 2003, p. 2, emphases added). Our nation cannot financially afford a universal health care system, - it is frequently maintained. Against this background, the PNHP argue that m*oney* is *not* an obstacle for a national health care system in the U.S. The problem is "not the money; it's the system," – as Angell put it (Angell, 2003, p. 2). To begin with, money cannot possibly be an obstacle for a health care reform in a nation that already spends the largest amount of money on health care (both in absolute terms, per capita, and as a share of gross domestic product (GDP)) compared to all other developed industrialized countries (ibid., 2003). Consider that in 2007, the U.S. spent $2.3 trillion or 16

percent of its GDP on health care, amounting to $7600 per person (The National Coalition on Health Care, 2007). U.S. health care spending is almost twice as high as the OECD average (15.3 percent of GDP vs. the OECD average of 8.9 percent of GDP in 2006). While the U.S. spent 15.3 percent of GDP on health care in 2006, health care expenditure in France, Germany, and Canada was between 10 and 11 percent of GDP (2006) (see exhibit 1 below for more details).While the U.S. spent $6714 per capita on health care in 2006, Canada's per capita spending was only $3678, while the OECD average was $2824[3]. Compared to our multi-payer system of health care financing, the nations with universal (or nearly universal) single-payer systems spend much less on health care.

Exhibit 1



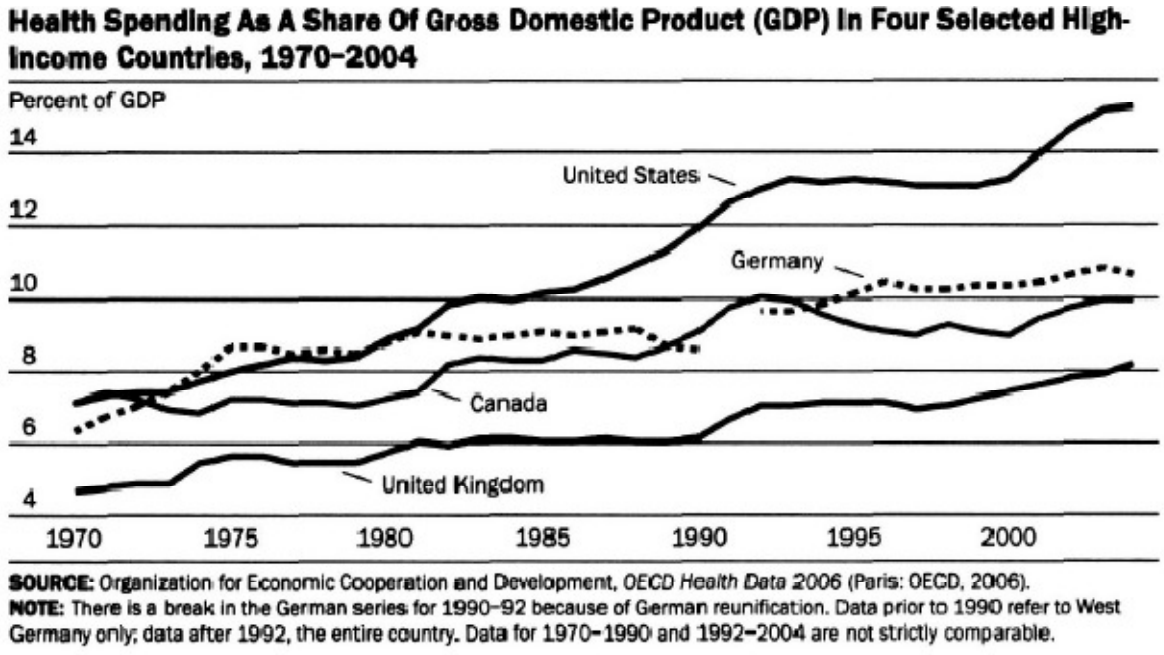
Source: OECD Health Data, available on http://www.oecd.org/dataoecd/46/33/38979719.pdf

[3] OECD Health Data, available on http://www.oecd.org/dataoecd/46/33/38979719.pdf

However, while the U.S. spends the largest amount of money on health care, this does not translate into better health care indicators. To the contrary, credible international comparative studies of infant mortality, life expectancy, immunization rates, etc. show that the U.S. health care system underperforms single-payer systems on these and other health indicators (Angell, 2003; Schaeffer, 2007). For example, according to the World Health Organization, the U.S. ranks thirty-first on life expectancy, thirty-sixth on infant mortality, twenty-eighth and twenty-ninth on male and female healthy life expectancy, respectively (Berwick et al., 2008, p. 759).

One of the implications of these comparative statistics is that health care financing methods (e.g. single-payer vs. a multi-payer system) influence *both* health care outcomes and costs. Because this paper is primarily concerned with the *economics* of health care, we will narrow our further discussion to the relationship between health care financing methods and health care costs (including their growth rates, i.e. inflation).

Exhibit 2



Source: Hsiao, 2007, p. 958.

Exhibit 2 above compares growth rates in health care spending (as a percentage of GDP) in the U.S., Germany, Canada and the U.K during 1970-2004. As Exhibit 2 demonstrates, the countries' health care spending growth rates *diverged* significantly in the post-1970 period, while the largest growth in health care spending was experienced in the U.S. According to Hsiao (2007), these developments imply that health care financing policy (i.e. multi-payer vs. single-payer method) "can play a major role in containing health spending inflation" (Hsiao, 2007, p. 958). The American multi-payer system financed by the U.S. employers, government, individual out-of-pocket expenditures, health savings accounts, etc. seems to carry a much larger inflationary potential compared to (predominantly) single-payer systems in Germany, Canada and the U.K. (among other nations). As Hsiao (2007) concluded, a "multichannel public and private health care financing approach such as that used by the United States is unlikely to contain health spending inflation" (ibid., 2007, p. 958).

Why is there a relationship between health care costs (and their growth rates) and health financing policy? Why is it that a single-payer health financing method is more cost-effective compared to a multi-payer method? To begin with, this is *not* because universal single-payer systems offer worse and less health care to their citizens. On the contrary, as was discussed above, single-payer nations boast healthier citizens with longer life expectancies. Hence, skimping on care is *not* the reason why universal single-payer systems generate a smaller health care bill.

There are several economic reasons behind the cost-effectiveness of a single-payer health financing method. Firstly, a single-payer system eliminates the enormous administrative expenses associated with a system of multiple health insurance providers. "The need for more than 850 health insurance companies to sell and contract with millions of employers,

underwriting each one, adds greatly to the administrative overhead costs" (Enthoven and Fuchs, 2006, p. 1541). These administrative costs typically consume about 11 percent of the health care premium, "and this does not include the costs to employers to purchase and maintain health care spending, including armies of consultants, benefit managers, and brokers" (ibid., 2006, p. 1541). Secondly, a single-payer system (or universal social insurance) eliminates the expenditures for advertizing, marketing and sales, etc. associated with a system of competing insurance companies (Angell, 2003; HNHP, 2003). The *overall* expenses associated with administration, billing and marketing (advertizing, etc) consume almost one third of the nation's health care bill (Angell, 2003; Hsiao, 2007, p. 957).

> The reason we spend more and get less than the rest of the world is because we have a patchwork system of for-profit payers. Private insurers necessarily waste health dollars on things that have nothing to do with care: overhead, underwriting, billing, sales and marketing departments as well as huge profits and exorbitant executive pay. Doctors and hospitals must maintain costly administrative staffs to deal with the bureaucracy. Combined, this needless administration consumes one-third (31 percent) of Americans' health dollars[4].

Thirdly, a national, non-for-profit health care system leaves no place for *exuberant profits* made by insurance companies, drug and equipment manufacturers, health care delivery institutions, and eradicates *exorbitant executive compensations*. According to PNHP's estimates, out each health care dollar spent in the U.S., no more than 50 cents actually reaches health care providers (Angell, 2003). This means that out of $2.3 trillion health care dollars spent in the U.S. in 2007, $1.15 trillion were consumed by profits, CEO compensations, administrative expenses, advertizing, marketing, and sales promotion, etc.

Fourthly, as a *monopoly purchaser* of health care services, drugs, equipment, etc., a single-payer system becomes the cornerstone of cost-containment (control), as the experience of

[4] http://www.pnhp.org/facts/single_payer_resources.php

Canada and European countries has demonstrated. For example, as a monopoly purchaser, the national health care agency can exert substantial price pressure on pharmaceuticals and equipment manufacturers, paying for their products based on the costs incurred (excluding marketing, lobbying, etc.) rather than with the aim of supporting exuberant profits and CEO compensations (PNHP, 2003a, p. 2). Similarly, a national health care agency would negotiate and establish a formulary for physician, hospital, and other medical fees, or allocate global budgets to health care delivery institutions. Notably, global budgeting can play an important role in cost containment by encouraging efficiency in the use of health care resources. "In contrast, relying on private insurance or direct out-of-pocket payment decentralizes health spending and budget decisions to individual health insurance plans and patients, respectively. In the latter case, providers can practice cost shifting and price discrimination among different payers" (Hsiao, 2007, p. 959). They face a lesser budget constraint and are less concerned about efficiency (ibid., 2007, p. 959).

Besides, unlike private insurance companies that are driven by profit incentives, a national non-for-profit health care system has a direct interest in rationalizing resource allocation (both real and financial) in such a manner that more is spent on preventive care to reduce the incidence of illnesses and to prevent chronic diseases "from becoming acute problems requiring costly treatment" (ibid., 2007, p. 958). Viewed from a patient's perspective, the current health care system discourages preventive care by imposing various co-payments and deductibles, etc. on patients. This especially endangers the most vulnerable – the poor and those with chronic diseases (NNHP, 2003, pp. 799 – 800).

Further, a single-payer system enables cost-control by moderating the diffusion of new expensive technology and drugs that are not cost-effective (and in many cases not really

necessary to meet the patients' needs). As a rule, the diffusion of such technology leads to health spending inflation as medical institutions attempt to pass their capital expenditures onto the patients' bills (ibid., 2007).

As PNHP argue, a single-payer system is the only way to recapture the enormous financial and real resources consumed by administration, advertising, marketing, exuberant profits and executive compensations, diffusion of new expensive technology, price discrimination, lack of preventive care, etc. associated with the current health care system. As the PNHP estimated in 2003, the potential savings on paperwork alone would be enough to provide comprehensive coverage to everyone without paying more than the nation already does (PNHP, 2003a; Woolhandler and Himmelstein, 2002, p. 22).

> Independent estimates by several government agencies and private sector experts indicate that NHI[5] would not increase total health care costs. Savings on administration and billing, which would drop from the current 30% of total health care spending to perhaps 15%, would approximately offset the costs of expanded services. Over the long run, improvements in health planning and cost containment made possible by single-source payment would slow health care costs escalation. (PNHP, 2003, p. 802)

Similarly, The Institute of Medicine (IOM) Committee on the Consequences of Being Uninsured estimated that universal health insurance would boost health care spending by just 3-6 percent (Newhouse and Relschauer, 2004, p. 180). Against this background, consider that annual health spending inflation in the U.S. is of the order of 4-5 percent (Aaron, 2007, p. 1630). Thus, universal health insurance "is not costly" relative to U.S. current expenditures on health care and their annual growth rates (Newhouse and Relschauer, 2004, p. 180). As far as American workers are concerned, a universal health insurance would actually lower their health care expenses. As PNHP estimated, a 2 percent income tax that would replace insurance premium contributions,

[5] National Health Insurance

deductibles, co-payments, co-insurance and other out-of-pocket expenses would be far less than what Americans pay under the present health care system. Similarly, for those employers who currently provide decent health benefits, a 7 percent payroll tax that would replace their current expenses on employees' health would be less expensive[6].

Based on such estimates, PNHP argue that the problem with transition to universal coverage in the U.S. is not financial. A national health care system would be able to provide a comprehensive coverage of the entire American population without spending much more than the nation already does. Rather, the problem is political, institutional, and ideological, nurtured by a system of special interest groups supportive of the *status quo*.

It will be argued in this paper, that an important aspect of the political-institutional problem is the so called principle of 'sound' federal finance, or an idea that federal budgets should be balanced over the course of a solar year. It is a belief that government spending is financed and, hence, constrained by public taxation and government borrowing from domestic and foreign entities. It is a conviction that persistent federal deficits and national debt are detrimental to a nation's economic and foreign security, and should be avoided. This 'sound finance' framework places the discussion of a health care reform in a context of "financial basics: taxes and budgets"- the books have to balance before a national health care reform is undertaken (*Health Affairs,* 2008, p. 621). Universal health care reform is 'unaffordable', - it is argued, - because federal budgets have already plunged into deep deficits (Lemieux, 2003, p. 1; Newhouse and Relschauer, 2004, p. 179). Besides, it is commonly claimed that a universal health care system would further raise the nation's health care bill. As the above discussed demonstrated, this claim is unsubstantiated. To the contrary, a universal, comprehensive, single-payer health care system is not costly relative to what the U.S. already spends on health care

[6] http://www.pnhp.org/facts/singlepayer_faq.php#raise_taxes

(while it still leaves 47 million uninsured). However, even *if* (hypothetically), universal health care largely increased our nation's health care bill, thus causing federal budget deficits to rise, - we will argue, - that this is *not* a 'problem' for a nation operating with a sovereign currency in a flexible exchange rate regime.

To understand why this is so, the next section will introduce the framework of Functional Finance as an alternative approach for the understanding and conduct of government fiscal, budgetary and monetary policy. It will be argued that rather than with *money* the problem rests with 'self-imposed' constrains on government spending, such as a 'sound finance' principle of balancing federal budgets, etc. Further in this paper, an institutional and accounting analysis of modern government spending, taxing, and open market operations (i.e. sales and purchases of government securities) will demonstrate that taxes and bond sales do not serve as a 'financing' operation for the government. Rather, they perform quire different functions. It will be argued that the 'money problem' imposed by the *dogma* of 'sound finance' rather than by the actual availability of finance *is* the barrier to universal health care reform in the U.S.

Abba Lerner, Functional Finance, and the 'Money-Problem' Fiction

In the 1940s, Abba Lerner presented the framework of Functional Finance as an alternative to then (and now) dominant framework of Sound Finance. Both Functional and Sound Finance refer to a set of guidelines (principles, ideas) that should govern federal fiscal, budgetary and monetary policy. The central ideas of Sound Finance are well known to economists, media experts, politicians, and general public. Firstly, it is a belief that public taxation provides the federal government with the 'revenue' it 'needs' in order to spend on goods and services, and various social programs, etc. Secondly, it is argued that once tax revenues fall short of the federal

government's projected expenditures, the government has to raise taxes and/or 'borrow' in order to obtain the extra funds it needs to carry out its fiscal 'over-commitments'. The supposition is that such borrowing is performed via the sales of government securities (e.g. Treasury-bonds) to domestic and/or foreign entities. The common presumption is that 'market forces' determine the maximum quantity of debt the government can issue (Wray, 1998). While most 'sound finance' adherents would agree that in *some* circumstances (e.g. a deep recession) it is inevitable that the federal government will run into budget deficits and national debt, they would argue that persistent budget deficits and national debt must be avoided (Wray, 1998, p. 74). The case of a financial burden imposed on future generations is commonly evoked here: future tax-payers will bear the burden of interest and principal repayment on government debt. Similarly, the dreadful thoughts of diverting taxpayers' money into interest payments to 'foreigners' are commonly stirred in the public's mind. To avoid these threats to national economic and foreign security, - it is maintained, - federal budget deficits and debt incurred during recessions must be offset by surpluses generated during economic expansions (ibid., 1998, p. 74).

Indeed, we have become so accustomed to this 'sound finance' framework that any alternative that might be presented to us may seem outrageous and absurd. However, despite our strong feelings about the soundness of 'sound finance', Lerner did not waver to present an *alternative* approach to federal fiscal, budgetary and monetary policy that he believed was a key to a nation's prosperity (which Lerner perceived as full employment and price stability). To begin with, Lerner was guided by pragmatic ways of thinking about the conduct of government policy. He believed that government policy should not be carried out according to long-existing 'preconceptions', 'norms', or canons of what is 'sound' or 'unsound', of what is 'proper', of what 'is done' traditionally', but, rather, according to the *effects* that the government policy

would have on national prosperity (i.e. full employment and price stability). Guided by these pragmatic, rather than scholastic considerations, Lerner formulated a viable alternative to the 'sound' finance framework. He dubbed it as a '*functional*' finance approach, rooted in the pragmatic maxim of undertaking government policy actions "with an eye only to the *results* of these actions on the economy and not to any established traditional doctrine about what is sound or unsound" (Lerner, 1943, p. 39). In other words, Functional Finance implies "the simple principle of giving up our preconceptions of what is proper or sound or traditional, of what "is done," and instead considering the *functions* performed in the economy" by government operations such as spending and taxing, selling and purchasing government securities, creating and destroying money, etc. (ibid., 1943, pp. 50-51).

In explicating the central ideas of Functional Finance, Lerner (1943) formulated the two central pillars of this pragmatic approach. The first pillar is concerned with the maintenance of full employment and price stability, which Lerner believed were the primary responsibilities of the government. "The first financial responsibility of the government … is to keep the total rate of spending in the country on goods and services neither greater nor less than that rate which at the current prices would buy all the goods that it is possible to produce" (ibid., 1943, p. 40). If the total rate of spending is above this level, there would be inflation, while in the opposite case (i.e. the total rate of spending is less than that which is necessary to purchase all the goods and services produced and imported) there would be deflation (ibid., 1943, p. 40).

How can a federal government maintain the total rate of spending in the economy at such a level that all the goods and services produced would be purchased? In other words, how can a federal government prevent inflation or recession? In order to prevent recessions, - Lerner argued, - the government can spend more itself or reduce taxes" (ibid., 1943, p. 40). Clearly,

reducing taxes would stimulate private spending by increasing the disposable income that the private sector has available to spend. Increased consumer spending would stimulate new investment, generating additional employment, additional income, leading to further consumer spending, investment, income and so on and so forth. What is less understood is that government spending, in particular, *deficit*- spending, does not "crowd out" private expenditure, but, rather, stimulates it by injecting net monetary reserves into the economy. This is "for the simple reason" that in the case of deficit-spending "the total value of checks issued by the Treasury to finance expenditures would exceed the total value of checks written by the private sector to pay taxes" (Wray, 2000, p. 14). In other words, the government would inject *more* money into the economy than it would drain from it via taxation, thus providing a net injection of reserves into the private sector and increasing the disposable incomes of consumers. This net injection of reserves is necessary to close the 'demand gap' (i.e. a situation when private spending is not sufficient to purchase all the goods and services produced) that results from the private sector's propensity to save a portion of its income (Wray, 1998, p. 75). As Bell (1999) has put it, the solution to the 'demand gap' problem is "to make it incumbent on the government to cover the shortfall by spending enough to bring about full employment" (Bell, 1999, p. 3). The corollary of such spending is a federal budget deficit.

In the opposite case, i.e. when the level of spending in the economy is too high (the public demands *more* goods and services than can be produced and imported in any given period), this will cause inflationary pressures. In order to prevent inflation, the total level of spending in the economy has to be reduced. The government can achieve a reduced level of spending "by spending less itself or by raising taxes so that taxpayers have less money left to spend" (Lerner, 1943, p. 40). The corollary of such government actions is a federal budget

surplus, i.e. a situation when tax revenues exceed government spending or the "checks received by the Treasury exceed the value of checks issued by the Treasury" (Wray, 2000, p. 14).

In sum, by increasing government expenditure and lowering taxes when the total level of spending in the economy is too low; and doing the opposite (i.e. reducing government spending and raising taxes) when the total level of spending in the economy is too high, the "total spending can be kept at the required level, where it will be enough to buy the goods [and services] that can be produced by all who want to work, and yet not enough to bring inflation by demanding (at current prices) *more* than can be produced" (Lerner, 1943, pp. 39-40).

Notably, the implication of the first pillar of Functional Finance is that raising taxes is *not* in any way related to the government's 'need' to obtain funds in order to finance its purchases. In fact, *increasing* government expenditures are accompanied by *reduced* taxation when the total level of spending in the economy is too low (i.e. there is a 'demand gap'). Lerner made it clear that rather than a 'financing' operation for the government, taxation is a demand-management and inflation-control tool. Lowering/raising taxes will increase/reduce aggregate affective demand to the required level of spending (i.e. just enough to purchase all the goods and services produced) removing recessionary/inflationary pressures. In the words of Lerner, when "the rate of spending becomes too great, *then* is the time to tax to prevent inflation" (Lerner, 1943, p. 43). Taxation, emphasized Lerner, is "*never* to be undertaken merely because the government needs to make money payment" (ibid., 1943, p. 40). As a demand-management and inflation-control tool, taxation should "be imposed only when it is desirable that the taxpayers shall have less money to spend, for example, when they would otherwise spend enough to bring about inflation" (ibid., 1943, p. 40).

Ironically, the usual objection to the Functional Finance framework is that its implementation will prove inflationary. "Indeed, this is a standard (i.e. mainstream) argument against expansionary fiscal policy" (Bell, 1999, p. 7). However, this objection is fundamentally at odds with the Functional Finance framework the central idea of which is to make it incumbent on the government to prevent and control inflation. As was discussed above, this is achieved by increasing taxes (and, hence, reducing disposable income) when the total level of spending in the economy is too high, thus causing inflationary pressures. Rather than causing inflation, then, Functional Finance is on strong guard against it (Lerner, 1943, p. 48). Moreover, as Bell (1999) notes, the mainstream inflationary argument against Functional Finance applies to an economy that operates at *full* employment (Bell, 1999, p. 7). Yet, Functional Finance applies to an economy that operates at *less* than full employment level. The central aim of Functional Finance is *to bring* the economy to the level of full employment (through government fiscal and monetary policy). *Once* the level of full employment has been attained, Functional Finance precludes *any* additional spending (ibid., 1999, p. 7) because it would likely "cause inflationary pressures – except in the unlikely case that all additional income represents desired net saving" (Wray, 1998, p. 84). Hence, as Bell (1999) concludes, as a basis for a critique of Functional Finance, the inflationary argument "is not very compelling" and "appears to be wholly incompatible with the theory of Functional Finance" (Bell, 1999, p. 7).

As the above discussion implies, Lerner was well aware of the fact that to bring the economy to the level of full employment, persistent federal deficits would be required. However, Lerner did not view them as an economic threat to a nation. Rather, he fully realized that due to the public's propensity to save a portion of its income, federal budget deficits are a practical and theoretical "norm" in capitalist economies. Federal deficits are required to fill the

'demand gap' and maintain the necessary level of spending (Wray, 1998, p. 82-3). The adherence to this norm is vital for a well-functioning and prosperous economy. Thus, Functional Finance rejects the traditional doctrine of 'sound finance' or the principle of balancing the budget "over a solar year or any other arbitrary period" (Lerner, 1943, p. 41). Lerner recognized that there was no reason to suppose that the attainment of prosperity in a demand-constrained economy would "necessarily balance the budget over the decade any more than during a year or at the end of each fortnight" (ibid., 1943, p. 42). Because "money is a creature of the state", Lerner argued (1947, p. 313), the federal government could create as much money as needed in order to deficit-spend and stimulate the economy by filling the 'demand gap'.

But, as Lerner noted, the continued application of government deficit-spending in order to achieve full employment would produce "an automatic tendency for the budget to be balanced in the long run as a *result* of the application of Functional Finance, even if there is no place for the *principle* of balancing the budget" (Lerner, 1943, p. 42). As was noted above, because government deficit-spending injects net monetary reserves into the economy, it increases disposable incomes, stimulates consumer spending, generates new investment, employment and furthers economic growth (Wray, 1998, p. 84). As private spending and investment keep growing, the 'demand gap' narrows, and government deficit keeps contracting. At the same time, economic growth keeps tax revenues rising, further reducing the size of the federal deficit. Ultimately, the budget will be balanced or even in surplus, even though this is *not* the goal, but a by-product of persistent government deficits aimed at attaining full employment and price stability (Lerner, 1943, pp. 48-9).

> This increase in private spending makes it less necessary for the government to undertake deficit financing to keep total spending at the level which provides full employment. When … private spending is enough to provide the total spending

> needed for full employment, there is no need for any deficit financing by the government, the budget is balanced … (ibid., 1943, p. 49)

The second pillar of Functional Finance dismisses the conventional notion that the sales of government securities (e.g. Treasury bonds) are undertaken as a 'borrowing' operation by the government once it runs out of tax revenues and becomes fiscally 'over-committed'. Rather, Lerner argued that the government should sell Treasury bonds *only* when the overall level of reserves in the banking system is excessive, threatening to bid the interest rate below its desired level (via the attempts of the holders of money balances to lend them out) (ibid., 1943, p. 40). This means that rather than a method of borrowing, the sales of government securities serve as a reserve- and interest-rate maintenance operation (Wray, 1998; Bell, 2000). We will further address this point from the perspective of modern banking and federal finance.

Clearly, the balance sheet effect of the government sales of securities (e.g. Treasury bonds) is an increased level of national debt. However, this is a mere accounting effect, that presents "no danger to society, no matter what unimagined heights the national debt might reach" (Lerner, 1943, p. 42). This holds true as long as the national debt is denominated in a national, sovereign currency, with a flexible exchange rate. In this case, the government can always create money to pay the interest and the principal on its debt (Lerner, 1947, p. 313). Taxation, Lerner argued, must *never* be undertaken with the purpose of collecting 'funds' in order to 'repay' the government's debt (Lerner, 1943, pp. 42, 50). Recall that taxation is a demand-management and inflation control-tool, rather than a financing method for the government.

Lerner realized that unlike individual's spending that is constrained by his/her budget and the ability to incur debt, there are no *inherent* financial constraints on the levels of debt and deficit that a sovereign government can incur. Because a sovereign government spends by

issuing its own IOUs, the only constraints on its spending can be institutional (e.g. regulations, accounting rules, etc.). Such constrains are not *inherent* financial constraints, but institutional limitations imposed by people (we can call them 'self-imposed' constraints) (Wray, 1998). They are "of necessity arbitrary" and "can be finessed and changed" (Wray, 1998, p. 84). However, this is not to imply that such constraints may not be politically necessary (Wray, 2000, p. 4).

> Government might well enact provisions that dictate relations between changes to spending and changes to taxes revenues (a balanced budget, for example); it might require that bonds are issued before deficit spending actually takes place; it might require that the treasury have "money in the bank" (deposits at the central bank) before it can cut a check; and so on. These provisions might constrain government's ability to spend at the desired level. However, economic analysis shows that they are self-imposed and are not economically necessary – although they may well be politically necessary. (Wray, 2006, p. 14)

Setting aside these 'self-imposed' institutional limitations, government's money is "a resource that is potentially unlimited in supply" (Wray, 1998, p. 84). While Lerner (1943, p. 41) talked about 'printing money' in the 1940s, the ways of government spending have changed since then. Modern governments do not have to resort to 'printing' money in order to spend. This will be discussed in the following section which analyzes the institutional and accounting procedures by which the U.S. government spends. At the same time, we will examine the real functions performed by taxation and bond sales/purchases in modern nations operating with sovereign currencies in flexible exchange rate regimes.

Government Spending, Taxing, and Open Market Operations in Sovereign Nations

Firstly, let us clarify the modern meaning of the term 'printing money'. As Bell (1999) explains, while the term 'printing money' is still habitually applied by economists, it is used in a metaphorical rather than literal sense: "Economists typically apply the term 'printing money' to

the crediting, by the monetary authority, of the fiscal authority's checking account as a consequence of purchasing its debt instruments" (Bell, 1999, p. 4). For example, think of the Federal Reserve Bank (the Fed) crediting the checking account of the U.S. Treasury after purchasing Treasury bonds. Rather than 'printing' money, this operation involves a change in a number in the Fed's computer system showing an increase in the electronic balance of the Treasury's checking account at the Fed. In this way, the government is provided "with a self-constructed spendable balance" (Bell, 2000, p. 612), while no 'printing' of money has actually taken place. As Bell (2000) emphasizes, the sale of the Treasury bonds to the Fed that accompanies such money creation "is simply an internal accounting operation" reflected on the consolidated balance sheet of the government (i.e. the sum of the Treasury's and the Fed's balance sheets with offsetting assets and liabilities cancelling one another out). Although 'self-imposed' or institutional constraints may preclude the Treasury from creating all of its spendable balances in this manner, there are no *inherent* financial constraints to prevent it from doing so (Bell, 2000, p. 612).

Once the Treasury makes a decision to spend, it does so by writing a check on its account at the Fed[7] (ibid., 2000, p. 604). The recipient of the Treasury's check will 'cash' it at his or her bank by either withdrawing the money, or, which is more common, by depositing the check into his or her account (Wray, 1998, p. 77). This increase in the depositor's account balance will be accompanied by the Fed's credit to the bank's reserves (ibid. 1998, p. 77). In this way, the Treasury's spending provides a net credit of reserves into the banking system. Note, that before the Treasury spends, the balance at its account at the Fed "does not comprise part of the money

[7] This will increase the Treasury's liabilities by the amount of the expenditure. These liabilities will be offset by an increase in the Treasury's assets (in the case of a Treasury's purchase). Alternatively, if the Treasury issues a payment (check) for some of the government's programs (e.g. a social security check), this payment will retire some of the Treasury's outstanding liabilities by the amount of the check issued. (Wray, 1998, p. 77)

supply or high-powered[8] money, but that *when it does*, the funds become part of the money supply (M1 if deposited into checking accounts, M2 if into savings accounts, etc.) *and* part of the monetary base" (Bell, 2000, p. 615). Thus, government spending from the Treasury's account at the Fed "creates an equivalent amount of new money (M1, M2, etc., *and* high-powered money)", i.e. injects net reserves into the banking system (*ceteris paribus*) (ibid., 2000, p. 616).

What if the Treasury decided to spend by writing a check on its account at the Fed, but there was 'no money' in the Treasury's account? Would the Treasury's check bounce? Clearly, this would never happen in the U.S. – a country that operates with a sovereign currency in a flexible exchange rate regime, with close coordination taking place between the Treasury and the Fed. "The Fed would, as a matter of course, offer an overdraft to the Treasury, essentially lending reserves as necessary", i.e. in the full amount of the Treasury's check(s)[9] (Wray, 1998, p. 116). Thus, the Treasury does not need to 'have money' in its account at the Fed, as long as the Fed decides to clear the Treasury's check(s) by offering it an overdraft. Because the Fed would *always* decide to clear the Treasury's checks, the implication is that the U.S. Treasury can spend "before and without regard to either previous receipt of taxes or prior bond sales" (ibid., 1998, p. 78). As a matter of fact, it would be practically impossible for the Treasury to consistently carry out its spending in a different manner. There are several reasons for that.

Firstly, consider that it is impossible to accurately determine in advance the amount and the timing of tax receipts because they are received and processed irregularly over the year (Bell,

[8] High-Power Money (HPM) is another name for the monetary base, or the sum of currency held by the non-bank public and banks' reserves (Croushore, 2007, pp. 460, 451).

[9] As a result of this transaction, the Fed's liabilities would increase, while there would be an offsetting increase in its assets in the form of the Treasury's IOUs. Recall that this is "nothing more than an internal accounting procedure", while the real result is that the Treasury would spend "by creating money" and commercial bank reserves would increase as a consequence of the Treasury's spending (because most of the Treasury's checks would likely be deposited into bank accounts; even if you decide to withdraw cash and further make a cash purchase, the seller will likely deposit his sales revenues into a bank) (Wray, 1998, p. 116).

2000, p. 605). This makes it impossible for the Treasury to perfectly coordinate its tax receipts and expenditures (ibid., 2000, p. 606). Secondly, the Treasury cannot, in principle, withdraw taxes from the economy before it spends first (Wray, 1998, p. 78). Being "the only supplier of fiat[10] money", the government cannot possibly receive in taxes the money it has not provided to private sector in the first place (ibid., 1998, p. 78). This is simply "a matter of logic": "the public cannot pay fiat money to the government to meet tax liabilities until the government has paid out fiat money to the public (ibid., 1998, p. 80). Government spending, then, determines the amount of money that is available to pay taxes, rather than the amount of tax revenues determining the extent of government spending, - as is commonly argued (ibid., 1998, p. 81). As Wray (1998) put it, the "government certainly does not need to have its own IOU *returned* before it can spend; rather, the public needs the government's IOU before it can pay taxes (ibid., 1998, p. 116).

Thirdly, one should understand a purely technical (accounting) matter that the Fed's notes and reserves are booked as liabilities on the consolidated government balance sheet, and that these liabilities are extinguished once they are paid to the state in the form of taxes (Bell, 2000, p. 614). In other words, once the state accepts its own money in payment of taxes, an equivalent amount of government liabilities is eliminated from its balance sheet, or simply destroyed (ibid., 2000, p. 614). More specifically, when demand deposits are used to pay taxes, the bank money (M1) is destroyed, while "the government's money, high-powered money, is destroyed as the funds are placed into the Treasury's account at the Fed" (ibid., 2000, p. 615). Viewed from this perspective, - argues Bell (2000), - the proceeds from taxation "cannot possibly finance the government's spending" because "the government must [first] destroy what

[10] Fiat money can be defined as "state liabilities issued to purchase goods, services, or assets or to discharge … liabilities, with no promise to convert" (Wray, 1998, p. 12) (i.e. no promise to convert money into other assets, as, for e.g., during the Gold Standard money could be converted into gold on demand). The primary source of value for fiat money is the government's promise to accept it in payment of taxes to the state. Thus, we can characterize fiat money as money that has value because the government accepts it in payment of taxes.

it has collected" (ibid., 2000, p. 615). Clearly, government expenditures cannot be funded by money that is destroyed when it is received in payment to the state (ibid., 2000, p. 615).

Similar to taxation, the sales of Treasury bonds to the private (including banking) sector ultimately lead to the destruction of high-powered money (ibid., 2000, p. 616). This means that neither bond sales nor taxation can be viewed as a 'financing' operation for the government. Rather, they perform quite different functions. As was discussed above, taxation serves as a demand-management and inflation-control tool due to its power to remove excess monetary reserves from the private sector. Draining excess reserves via taxation reduces disposable income thus curtaining aggregate demand and removing inflationary pressures.

Yet, there is another function performed by taxation that we have not discussed yet. Think of why the public accepts the government's money which has no intrinsic value (and is not backed by any asset with an intrinsic value, e.g. a precious metal)? According to the Chartalist perspective in the tradition of G. Knapp, A. Lerner, L. R. Wray, S. Bell[11], *et al*., the *primary* reason the public accepts the government's currency is because the public's *liabilities* to the government are denominated and must be extinguished in that currency. All of us are well aware of those liabilities called taxes. Hence, the argument is that the *function* of taxation is to create the *primary* demand for the otherwise worthless[12] government money. In other words, the *primary* reason for the public's acceptance of the government's money in payment for goods and services (both in private exchanges and transactions with the government) is the need on the part of the public to obtain the government's money in order to pay taxes.

[11] Currently publishing as Stephanie Kelton.
[12] The cost of producing a piece of U.S. currency is about 4 cents (Croushore, 2007, p. 6). Hence, the U.S. currency's intrinsic value is close to nothing. Moreover, the U.S. currency is not backed by any asset that has an intrinsic value.

> … without the tax system to underlie demand, it is difficult to imagine that the public would continue to use HPM[13] in private exchanges, and even more difficult to imagine that the public would sell things to the government in exchange for HPM, if HPM were not needed to make payments to the government. (Wray, 2000, pp. 9-10)

However, this argument should not be mistaken as an argument about the *only* reason for the public's acceptance of government's currency. Clearly, there are other motives, such as the stability of a currency over time, the trust in the government, etc. that induce the public to accept and hold a government's currency. The argument is, rather, that if the tax system were removed, the government would *eventually* discover that the private sector is no longer willing to accept the government's money in payment for goods, services, and assets[14] (Wray, 1998, p. 81).

In sum, the *primary* function of taxation is to create demand for government money. To achieve its purpose, the "tax burden must be sufficiently great" (ibid., 2000, p. 9). Beyond that, taxation is used to drain excess reserves from the economy in order to mitigate inflationary pressures that would result if the disposable income were beyond the level required to purchase all the goods and services produced (and imported) (ibid., 2000, pp. 9-10). Alongside its inflation- and aggregate demand- management function, taxation serves as a reserve-maintenance tool for the banking system.

Let us now turn to the real function performed by the sales and purchases of government securities, e.g. Treasury bonds (also known as 'open market operations'). Above we mentioned that open market operations perform a reserve- and interest-rate maintenance function, however,

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[13] High-Powered Money: see ft. 8 above for a definition of this term.

[14] Of course, following the removal of the tax system, an "inertial demand" for the government's money would exist for some time, because the public would become so much accustomed to its use in private transactions. However, *eventually*, this demand would disappear and the public would resort to some other form of currency (Wray, 2000, pp. 9-10).

we did not provide a detailed discussion of this important point. We aim to pursue this discussion below.

Firstly, it should be noted that banks are required by law to hold reserves against a certain fraction of their deposits (called 'required reserve balances'). However, banks earn no interest on reserves held in excess of the required amount. Therefore, banks will normally prefer not to hold substantial excess reserves. Rather, they will attempt to eliminate the excesses by trying to lend them out to each other in order to earn interest. For this purpose, the 'federal funds market' is the "market of first resort" (Bell, 2000, p. 606).

How could a situation of substantial excess reserves result within the banking system? In other words, what could be the source of these excessive non-interest bearing reserves that the banking system normally does not wish to hold? The most important source of these excessive monetary balances is government deficit-spending (on goods, services, social programs, etc). Recall that deficit-spending injects net reserves into the banking system. This normally leaves the banks with *more* reserves than they need or prefer to hold (Bell, 2000).

While the fed funds market may help some individual banks eliminate their excess reserves by lending them out, this market cannot help the banking system *as a whole* to rid itself of excessive reserve balances. Rather, the attempts by the banks to lend out excessive reserves will put a downward pressure on the fed funds rate, ultimately leading to a zero percent bid (Bell, 2000, p. 606; Wray, 1998, p. 86). However, the maintenance of a targeted level of the fed funds rate (also known as the 'overnight lending rate') is a primary focus of monetary policy. This rate is of paramount importance because it serves as an "anchor for all other interest rates" (Bell, 2000, p. 606, citing Poole 1987, p. 11). With a fed funds rate target set by the monetary authority, it becomes largely non-discretionary for the Fed and the Treasury to intervene into the

fed funds market to prevent the overnight lending rate from falling below its targeted level when the banking system is flush with excess reserves. Clearly, to prevent the fed funds rate from falling below its policy target, excess reserves have to be drained *from* the banking system. This is achieved through the sales of the Treasury bonds which serve as an interest-bearing alternative to non-interest bearing reserves that the banking system attempts to eliminate[15] (Bell, 2000, p. 606; Wray, 1998, p. 86). In order to purchase Treasury bonds, commercial banks draw on their accounts at the Fed, while the Fed transfers the proceeds to the Treasury's account. In this way, the purchases of Treasury bonds by commercial banks drain reserves from the commercial banking system (Bell, 2000, p. 612).

This analysis clearly demonstrates that bond sales by the Treasury do *not* serve as a 'financing' operation for the government. Rather, open market sales by the government "are used to coordinate deficit spending, draining what would *otherwise* become excess reserves" (ibid., 2000, p. 613). Government securities provide the private sector with an interest-earning alternative to non-interest-bearing reserves, "allowing the government to spend in excess of taxation without driving the overnight lending rate down" (ibid., 2000, pp. 613-4). Another interesting implication of this analysis is that, contrary to the conventional view that government deficit-spending *raises* interest rates, it actually causes the lending rates to fall (as far as zero) by injecting excess reserves into the banking system (Wray, 1998, p. 87).

What about selling government bonds to foreign entities (e.g. banks)? The answer is that such sales perform exactly the same function as the sales of government bonds to domestic entities, i.e. they drain excess reserves from the banking sector by providing an interest-bearing alternative to non-interest-earning reserves. The sales of U.S. government bonds to foreign banks drain excess dollar-reserves from the foreign sector. As long as these bonds are denominated in

[15] The primary sales of bonds are undertaken by the Treasury, while the Fed uses reverse repos (Wray, 1998, p. 86).

the U.S. dollars (i.e. our national fiat currency), "they do not entail any 'risks' that domestically held bonds do not hold". The interest on such bonds "can always be paid through creation of fiat money – just as any other government spending is financed through creation of fiat money" (Wray, 1998, p. 88).

Now, while government deficit-spending injects net reserves into the banking system, taxation achieves the opposite effect. When tax-payers write checks to the Treasury by drawing on their accounts at commercial banks, this *drains* reserves *from* the banking system (Wray, 1998, p. 80; Bell, 2000, p. 606). The loss of reserves through tax payments will leave the banking system short of required or desired reserves. In this case, commercial banks will turn to the fed funds market to *acquire* the reserves they need to meet their reserve deficiencies. Again, while some individual banks may be successful in acquiring the extra reserves they need, a *system-wide* shortage of reserves cannot be eliminated through the fed funds market. Rather, the overnight lending rate will be bid higher, ultimately exceeding the fed funds target rate. To prevent the fed funds rate from rising above its policy target, the extra reserves will have to be *injected into* the banking system. To achieve this, the Treasury and/or the Fed will start *purchasing* government securities *from* the banking system, thus injecting additional reserves into the system (Bell, 2000, pp. 606-7).

In sum, government spending/taxation disrupt the desired (or required) reserve positions of commercial banks by injecting/draining reserves into/from the commercial banking system. To eliminate excess reserves or alleviate reserve deficiencies that would normally result from government spending or taxation, respectively, the banks would turn to the fed funds market – their "market of first resort". However, the fed funds market cannot eliminate *system-wide* excesses or shortages of reserves, making it largely non-discretionary for the government to

intervene in order to maintain its fed funds rate target. In the absence of government draining or injection of reserves, the overnight lending rate would be bid below or above its policy target, further affecting all other short-term interest rates (Bell, pp. 606-7; Wray, 1998, p. 78). Viewed from this perspective, the sales and purchases of government securities should be considered as monetary policy operations, rather than fiscal policy operations (e.g. a 'financing' method for the government) (Wray, 1998, p. 86-7). Likewise, as Bell (2000) has argued, the debate over alternative 'financing' methods is really a debate over the alternative ways of draining excess reserves (i.e. taxation vs. bond sales) (Bell, 2000, p. 617). While taxation drains excessive disposable income when aggregate demand is too high, thus causing inflationary pressures; bond sales drain excess reserves from the commercial banking system allowing positive overnight lending rates to be maintained (Wray, 1998; Bell, 2000).

A 'Sound' Finance Approach Persists

Meanwhile, the 'sound finance' approach persists, as economists, politicians, media experts, students and general public continue to misunderstand the nature of modern, fiat money, and its implications for federal government's spending, taxing, and open market operations. Most economists and policy-makers in Congress still believe that taxation and the sales of Treasury bonds serve as a 'financing' operation for the federal government. In this taxation- and 'borrowing'- constrained fiscal climate, - it is argued, - the nation must face trade-offs between important spending categories. Due to insufficient *financial* (as opposed to *real*) resources, - it is maintained, - the nation has to prioritize between public health care, education, R&D investment, technological development, public infrastructure, etc. All of these vital programs cannot be fully implemented at the same time, - it is argued, - unless "potentially ruinous deficits" will be

generated. The media, academia, and policy-makers in Congress tirelessly paint to us "a *bleak future of soaring deficits leading to political and economic crisis*" (Aaron, 2007, p. 1623, emphases added). The nation has become so haunted by these dreadful thoughts of soaring federal deficits, that some have dubbed them a "fiscal specter" or "a monster at our door". Other prominent examples of frightening rhetoric include D. Walker's , the director's of the Government Accountability Office, warning of a looming "*fiscal cancer"* that our nation is about to suffer as a result of "massive entitlement programs *we can no longer afford*" (ibid., 2007, p. 1623, emphases added). Another piece of rhetoric comes from a Boston University economist L. Kotlikoff and his collaborator, S. Burns, who foresee "*a government in desperate trouble*" (ibid., 2007, p. 1623, emphases added).

The 'sound finance' recipe for this budgetary 'crisis' is to close the 'fiscal gap' by increasing taxes and slashing government spending. The resulting picture is scary indeed: the government is "raising taxes sky high, drastically cutting retirement and health benefits, slashing defense, education, and other critical spending, and borrowing far beyond its capacity to repay" (ibid., 2007, p. 1623). In this growing discussion of 'financial affordability crisis', many have argued that our government's commitment to finance Social Security, Medicare, Medicaid and other public programs is "unaffordable unless taxes are increased (ibid., 2007, p. 1623-4).

When the discussion of universal health care reform is mistakenly placed within this context of a 'constrained fiscal climate', then rising taxes, cuts in federal spending and increased government borrowing seem to be the only solution to cover the 47 million uninsured Americans. But 'taxes are already way too high', - most Americans would object, while 'there is not enough spending left to cut', many policy-makers would argue (Aaron, 2007, p. 1628; Schaeffer, 2007, p. 1559)**.** With tax increases and spending cuts not a viable option, the U.S.

government will have to *borrow* more and more money (Schaeffer, 2007, p. 1559). But this will threaten our nation's economic and foreign security: "A huge deficit, funded by foreign countries, will be viewed as a threat to the nation's security. In the absence of draconian measures (for example, increasing taxes, cutting benefits…), future generations will have to bear the costs and the social and economic consequences" (ibid., 2007, p. 1559). The bottom line is "that universal coverage should not be attempted" because "the books have to balance before the deal can be closed (*Health Affairs*, 2008, p. 621).

Ironically, while the experience of Western countries demonstrates that universal coverage is a key to health care costs containment, the 'sound finance' adherents present it as a source of escalating health care expenses (Aaron, 2007, p. 1632). While PNHP and other research institutions estimate that universal, single-payer health care system would cover the 47 million uninsured Americans without spending any more than our nation already does, the 'budget hawks' claim that universal coverage would cause sky-rocketing health care expenditures, increased taxes, growing federal deficits, national debt, and cuts in other spending categories. These claims lead to erroneous projections that become self-fulfilling prophecies:

> After the 2008 election, budget hawks, focused on reducing deficits caused by Medicare and Medicaid, will begin proposing spending reductions. Soon thereafter, national security experts, intend on preventing foreign holders of debt from influencing U.S. policy, will demand even bigger reductions. Eventually, the two groups will combine forces to cut health care spending and, in doing so, will determine health policy for the nation. (Schaeffer, 2007, p. 1559)

Due to this mania to 'close the fiscal gaps', as well as other political, institutional and power factors, the U.S. remains the only industrialized nation that does not offer universal health care to its citizens. "We claim we cannot afford it" (Berwick et al., 2008, p. 760). The costs would be too high: an escalating budget deficit and 'foreigners' influencing the U.S. policy-making.

A Concluding Response from a Functional Finance Perspective: Is Universal Coverage Financially Affordable?

As discussed above, rather than a 'fiscal cancer' persistent government deficits are a theoretical and practical *norm* in demand-constrained economies (Wray, 1998, p. 75). The size of a federal deficit is not an issue: it is simply a book-keeping matter. The implication is that the 'sound finance' 'recipe' to avoid a 'fiscal meltdown' is a mal-prescription for a non-existing problem. This 'recipe' aimed at reducing the federal budget deficit will certainly lead the economy into a recession as the 'demand gap' will widen, reducing investment, employment and economic growth. As a consequence of the ensuing recession, the federal government will *have* to run fiscal deficits to stimulate the economy and fill the widened 'demand gap'. As a historical analysis demonstrates, attempts to balance the budgets were mostly followed by deep recessions, making deficit-spending inevitable (Wray, 2000).

Secondly, it is mistaken to think that the U.S. federal government can be financially constrained in a regime of a fiat currency with a flexible exchange rate. Rather than relying on taxation and borrowing, the U.S. government's spending "is always financed through creation of fiat money" (Wray, 1998, p. 75). Government's fiat money is a resource potentially unlimited in its supply. The significance of this is that the government can take advantage of its unique position in the monetary system and implement vital public programs, such as universal health care, without worrying about the availability of *financial* resources (Wray, 2006, p. 14). Universal, comprehensive health care can always be financed by direct creation of new money by the government. The government can create as much money as needed to finance the nation's health care bill. As explained above, this money creation does *not* involve the actual *printing* of money. Rather, it is reflected in a change of a number in the Fed's computer system, showing an

increased balance in the Treasury's account at the Fed. Any institutional constraints on government spending are 'self-imposed' (vs. *inherent*) limitations, and could be removed given the political will to do so.

While the government should *not* worry about the availability of *financial* resources, it should certainly worry about the availability of *real* resources (e.g. well-educated health care providers and personnel, quality health care delivery institutions, medical equipment, laboratories, drugs, technological and research base, etc.). This is the *real* issue. While some have compared *money* to "the mother's milk of health care" (Hsiao, 2007, p. 950), we would argue that it is *real* resources that are so vital for a well-functioning health care system. There are no inherent *financial* constraints to prevent the U.S. government from developing such resources.

Lastly, in the context of a health care reform debate, it has been common to compare state and federal budgets. While state finances *are* revenue-constrained because individual states do not issue their own currency, this does not apply to the federal government which can always spend by issuing new fiat money. When the distinction between state and federal finance is not grasped, the failure of health care reform experiments in budget-constrained states is evoked as an argument against a national health care reform: "universal coverage should not be attempted", - it is claimed, - because the "lesson of coverage experiments in both Massachusetts and California seems to be that the books have to balance before the deal can be closed" (*Health Affairs*, 2008, p. 621). This and similar claims misconstrue the positions of individual states versus the federal government in the monetary system. The states need the government's money to finance their expenditures, and have no power to create it, relying on taxation and borrowing instead. In contrast, federal government's expenditures face no inherent financial constraints, allowing the Treasury to spend before and without regard to taxation and/or borrowing.

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