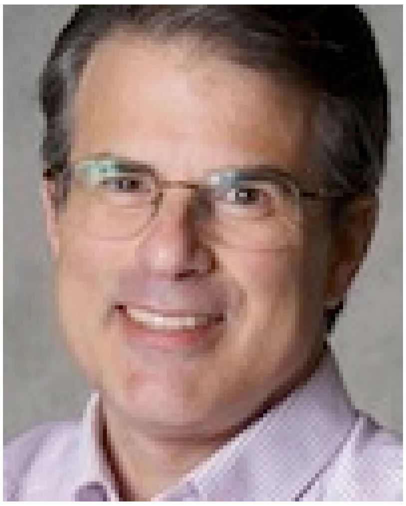
How MMT Became Clear To Me

By Kerry Pechter *Thu, Jul 16, 2020*

In colonial Virginia, the law required the burgesses to set the incoming tax receipts on fire. That taught me a key lesson about how our money works today.



Like countless other students of economics, I was taught that the U.S. government finances itself by taxing its citizens, borrowing from them, or stealing from them (i.e., by printing new dollars and watering down the money supply).

So I could never make much sense of the claim by proponents of Modern Monetary Theory that Uncle Sam spends *before* taxing or borrowing. That is, until I read a research paper about a 260-year-old scandal called the "John Robinson affair."

The scandal involved the defalcation (embezzlement) of a fortune in paper money in pre-Revolutionary Virginia. I learned about this crime from a 2015 research paper by Farley Grubb, a colonial money expert at the University of Delaware. His paper was subsequently cited in the 2019 MMT **textbook**, *Macroeconomics* (Red Globe Press).

Gold and silver coins (specie) were scarce in colonial America, especially after the French and Indian War with France. The Virginia House of Burgesses couldn't afford to pay for two pressing needs: a military squad (called the Rangers) and a Commissioner of Indian Affairs.

So the burgesses created money and taxes—simultaneously.

Under a new currency law, the burgesses authorized the issuance of paper money as legal tender. The bills, which essentially were IOUs of the colony, had expiration dates on them. The Acts also levied taxes that were, not coincidentally, payable with that very same paper money on the day it expired.

Between the issue date and expiration date, the paper served as circulating legal tender. The money passed from hand to hand, facilitating and catalyzing business activity. At tax time (the expiration date), people paid their taxes with it, or with specie.

If, after paying taxes, someone still held paper, he or she could redeem it for specie. After collecting the expired paper, the burgesses then burned it to make room for the next round of issuing paper—thereby preventing inflation.

Suddenly, for the first time, I had the missing link. MMT's claims made sense to me. Money finances taxes, and taxes finance money. Yes, we earn our money from an employer or a customer. Yes, there are "frictions." Nonetheless, the money originally comes from government spending (or from bank loans backed by reserves at the Federal Reserve) and returns to government in the form of taxes.

The implications are a bit head-spinning. If this is true, it means that the government doesn't rely on us for money; we rely on it. Or rather, we all rely on each other. It suggests—though this stretches the imagination—that we pay Social Security taxes not to fund Social Security but to carve out room in the economy for the arrival of Social Security benefits. It means that when banks buy Treasury bonds, they are, at least sometimes, buying them with money spent into the banking system by the government.

Here's an example of how it might work: The U.S. Treasury sends a Social Security check to a retiree. The check becomes a deposit in the retiree's checking account. The deposit appears in the bank's reserve account at the Fed.

When the individual writes a check, his bank's reserves cover the check. If the banks, collectively, have more reserves than they need, they can buy Treasuries. If they need more reserves to cover more checks, the Fed can buy Treasuries from them.

In a crisis, when the banks can't find buyers for their assets, the Fed will buy them. That gives banks the cash to cover the checks we write. The government's checks can never bounce because the Fed will always cover them.

But doesn't the Fed "print money"? Not really. In my new understanding—and I could be wrong—the government doesn't sell Treasury bonds to finance deficit spending. Instead, deficit spending gives banks the wherewithal to buy Treasury bonds. Either way, the Treasury's books look the same. The difference—and this was a key point of debate at the founding of our country—is that the central government isn't at the financial mercy of the private sector or the states. Quite the opposite.

If you believe money is *matter*—gold, ideally—and that your objective is to hoard what you can—then what I've just told you is sophistry, heresy or even blasphemy. If you believe that the government is illegitimate, and pilfers your money from your paychecks, you won't like it either. But if you look at money as *energy*—currency, literally, whose movement is its greatest virtue—then it makes sense.

In this paradigm, the Federal Reserve sits at the center of a financial power grid, ensuring that all valid checks get cashed expeditiously and that the banking system always has enough juice to keep the lights on in houses and businesses from Albuquerque to Zanesville.

In normal times, the Federal Reserve adds or subtracts liquidity from the system at the margins—mainly to push interest rates up or down. In major crises, it injects cash into the financial system by buying Treasury bonds, corporate bonds, or—for the first time in the spring of 2020—bond ETFs (exchanged traded funds).

What about the "John Robinson affair" that I mentioned earlier? Robinson served as Speaker of the Virginia House of Burgesses and the colony's treasurer from 1738 until his death in 1766.

After he died, the burgesses discovered that instead of burning the expired paper money—the tax revenue—as the law required, he recycled it to his friends. (Perhaps he altered the expiration dates; historical evidence is incomplete.) But "the resulting scandal reverberated through Virginia politics for years."