

LERNER, Abba Ptachya (1903-1982)

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Lerner was born in Bessarabia, Russia on 28 October 1903. After immigrating to England in 1906, Lerner earned a B.Sc., Economics, 1932 and Ph.D., Economics, 1943, both from the London School of Economics (LSE), and eventually received an honorary doctorate from Northwestern University in 1973. He was the recipient of a number of awards, fellowships, and prizes at LSE, including the Director's First Year Essay Prize (1930); Tooke Scholarship (1930); Hugh Lewis Essay Prize (1932, bracketed); both the Gonner and Gladstone Memorial Prizes for first place in B.Sc. in Economics (1932); LSE Research Fellowship (1932-4); and the Leon Fellowship of the University of London (1934-35). Lerner also began his academic career as an Assistant Lecturer at LSE (1935-37), and was a founding co-editor of the *Review of Economic Studies* from 1933-7. In 1937, Lerner emigrated to the United States, becoming a naturalized citizen in 1949, and, except for later visiting positions in teaching, research, and policy in Europe and Israel, remained there until his death in Tallahassee, Florida 27 October 1982.

Lerner had a Rockefeller Fellowship in the U.S. (1938-9), and began his academic career there as a visiting professor at the University of California—Berkeley (Spring 1938) and a Lecturer in Economics at Columbia University (Fall 1939-40). He then held positions at the University of [Missouri] Kansas City (Assistant Professor, 1940-2); New School for Social Research (Associate Professor, 1942-6; Professor, 1946-7); Roosevelt University (Professor, 1947-9); Michigan State (Professor, 1959-65); University of California—Berkeley (Professor, 1965-71); Queen's College, City University of New York (Distinguished Professor, 1971-8); and Florida State University (Professor, 1978-82). Lerner held visiting positions at the University of Virginia (Spring 1940); Amherst College (Fall 1942-3); Roosevelt College (Spring, Summer 1947); New School (Summer 1948, 1950); Hebrew University (1954-6); Columbia University (Spring, Summer 1957); Johns Hopkins (1957-8); Berkeley (1958-9; Summer 1960, 1962, 1973); Michigan State (Summer 1958, 1959); University of Hawaii (summer 1965); University of Tel Aviv (1965-6); and Florida State University (Winter and Spring 1976, 1977).

Lerner was also active in consulting and policy-making positions, public and private. He was a consultant to the Rand Corporation (Summer 1949), the Economics Commission for Europe (Geneva, Fall 1950-1), and the Institute for Mediterranean Affairs (1958-9), served on the Economic Advisory Staff in Israel (1953-5), and was an advisor to The Israeli Treasury and the Bank of Israel (1955-6).

Among his numerous professional honors and distinctions, Lerner was named a Fellow of the Econometric Society in 1950, the Center for Advanced Study in the Behavioral Sciences, Stanford, in 1960-1, and the American Academy of Arts and Sciences in 1971. He was named a Distinguished Fellow of the American Economic Association (AEA) in 1966 and an Honorary Fellow of LSE in 1970. Lerner also served as Vice President of the AEA (1963), Regent Lecturer at the University of California—

Santa Barbara (1964); President of the University Centers for National Alternatives (1973); President of the Atlantic Economic Society (1979-80), and President of the Western Economic Association (1983; deceased: James Buchanan, Acting President). Lerner was also named a Member of the National Academy of Sciences in 1974.

Keynes, in a letter written at sea on a voyage to the United States during which he read Lerner's *The Economics of Control* (1944) wrote to Lerner that he had 'written two books largely distinct...which you have placed within one cover' (Colander and Landreth, 1996, p. 116). This accurately describes not only the book, but Lerner's fifty years of economic scholarship, which covers both microeconomics and macroeconomics; neoclassical and Keynesian frameworks; theory and policy; and a faith in markets and a commitment to democratic socialism.

Lerner's early, energetically prolific years at LSE were prior to his introduction to the 'New Economics' (Keynes), though he had independently studied the works of some Marxist and institutionalist economists, and so reflected both his studies with Robbins, Hayek, J. R. Hicks and the other LSE faculty of the neoclassical marginalist microeconomics and his dedication to a brand of market socialism he would describe as 'socialist free enterprise'. Using plain English and plane geometry (Samuelson [1964, p. 170] would later refer to the Lerner of this period as a 'diagram man' who wrote 'ideal scientific prose'), Lerner clarified, extended, elaborated, and graphically depicted a number of concepts and proofs in Marshallian neoclassical theory and general equilibrium welfare economics. Many of these demonstrations would eventually become the standard textbook presentations of these concepts. His first publication, for example, written after studying economics part-time for two years, 'The Diagrammatical Representation of Cost Conditions in International Trade' (1932), was the first paper to use community indifference curves to demonstrate the equilibrium in a two-country model. This was followed by a number of papers that conducted similar geometric exercises for other concepts, including, e.g., the demand-side of trade theory, elasticity of demand, and elasticity of substitution (Lerner 1933a, 1933b, 1934a).

Two 1934 papers in the *Review of Economic Studies* demonstrate Lerner's transition from a clarifier and disseminator of economic principles to sophisticated inaugurator of new lines of research. 'The Concept of Monopoly and the Measurement of Monopoly Power' (1934b) demonstrated why marginal-cost pricing is a necessary and sufficient condition for 'Pareto-optimality' (allocative efficiency), the meaning of the 'social optimum' (no one can be made better off without making someone else worse off), and how perfect competition guarantees and monopoly precludes its attainment. This was nothing less than '[t]he first clear, rigorous and definitive statement of Pareto optimality' (Scitovsky, 1984, 1551). As Samuelson put it, 'Today this may seem simple, but I can testify that no one at Chicago or Harvard could tell me in 1935 exactly why $P=MC$ [price = marginal cost] was a good thing' (Samuelson, 1964, p. 173).

The second paper, 'Economic Theory and Socialist Economy' (1934c), was the initial contribution of five important papers on the theory of market socialism written by Lerner during his LSE years. Along with those of Fred M. Taylor and Oskar Lange

(Lerner's fellow student at LSE), Lerner's contributions dealt with a myriad of analytical issues involved in identifying the behavioral rules for attaining optimal resource allocation in a socialist economy. The 'Lange-Lerner Theorem' became a cornerstone of one side of the famous 'socialist calculation debate': in theory, a socialist economy could be at least *as* efficient as a private enterprise economy, provided the state planners employ the price system to realize allocative optimality as in a market economy (again, $P = MC!$); in practice, since a free market system never achieves the social optimum due to numerous market imperfections, a socialist economy in which prices are set as if in perfect competition will be *more* efficient.

Two additional papers from this period are worthy of note in that both remained unpublished until much later and so were eventually recognized to have anticipated important contributions by others. The first, 'Factor Prices and International Trade' (1952 [1933]), was nothing less than a demonstration of the 'factor price equalization theorem', a proof that (under the usual assumptions) product mobility was an adequate substitute for factor mobility in producing a tendency for factor prices (and not only product prices) to become equalized between countries engaged in free trade. When Samuelson (1948) published his proof of the theorem, Robbins recalled Lerner's presentation in a seminar fifteen years earlier and it was published in *Economica* in 1952. The other, 'Paleo-Austrian Capital Theory' (1980 [1931-2]), utilizing three-dimensional diagrams, demonstrated with two simple adjustments that Hayek's concept of the average period of production had the interest rate fully integrated in it, protecting it from criticisms by Frank Knight and John Hicks and rendering unnecessary the subsequent reformulation by Hicks. What is additionally remarkable is that the original paper could not be found, but Lerner had 'a vivid memory of the diagram from which I found it easy to reconstruct the content of the essay'—some 45 years later!

This work, all produced prior to Lerner's emigrating to the U.S. in 1937, established his reputation as a brilliant economist and much of it would be modified and extended in the first of the 'two books...placed within one cover', as Keynes referred to it, of his *magnum opus*, *The Economics of Control* (1944), which had also served as his doctoral dissertation. The 'second book' would cover macroeconomics and Keynesian theory, whereas the first was strictly neoclassical microeconomics, but what the two shared is Lerner's imaginatively-precise analytical powers, his laser-sharp deductive ability to push an argument to its furthest possible logical conclusion. Sometimes, when these arguments had been begun by others, the originators were astonished to find that their models led to conclusions they had never imagined (and sometimes of which they disapproved!).

Lerner's receipt of the LSE's Leon Post-Graduate Study Fellowship for 1934-5 funded his visit to Cambridge University, initially planned for two months to 'clear...up the nonsense' he had heard in some previous meetings with Joan Robinson, but which turned into six months, 'during which time they persuaded me they made sense' (Colander and Landreth, 1996, p. 90). The 'they' refers to the 'circus' of economists around the 'Political Economy Club' (or 'Keynes Club'), including John Maynard Keynes, Joan Robinson, Austin Robinson, Richard Kahn, and others such as Lorie

Tarshis and Robert Bryce. Lerner is thought to be ‘the first economist outside of Keynes’s inner circle to grasp the nature and importance of’ *The General Theory of Employment, Interest, and Money* (Keynes, 1936). While this experience resulted in a shift in Lerner’s focus from neoclassical microeconomics to Keynesian macroeconomics, he continued to apply a similar approach and methodology as in his earlier contributions, both as a clarifier and elaborator of concepts in straight-ahead scientific prose and an originator of new ideas through taking arguments to their logical conclusion.

His first contribution to this literature, ‘Mr. Keynes’ “General Theory of Employment, Interest and Money” (1936), which Keynes himself read and approved, was a ‘clarified popularization for sophisticated but non-theoretically oriented policy makers’, published in the *International Labour Review* (Sobel, 1983, pp. 8-9). In it Lerner demonstrated some of the simple but counter-intuitive results of the Keynesian model, such as the paradox of thrift (an attempt by an economy as a whole to increase its savings will cause consumption, income, and employment to fall, with savings remaining equal to investment). Lerner was an active participant in the flurry of articles attacking and defending the *General Theory* especially on the topics relating to savings and investment (e.g., Lerner, 1938).

Lerner’s move to the United States in 1937 did not interrupt his work, and coincided with the initial publication of the idea that would become his most enduring contribution, Functional Finance. In an article entitled ‘The Economic Steering Wheel’ (1941) published in the *University [of Kansas City] Review* while Lerner was on the faculty of the University of Kansas City (now University of Missouri—Kansas City), his first regular, full-time appointment in the U.S., he used the analogy of driving an automobile to defend the use of government controls to ‘steer’ the economic system onto the right path. While respecting market forces, Lerner likened *laissez-faire* to a refusal to take hold of the ‘economic steering wheel’. The article was the first to lay out the principles of Functional Finance, although he had not yet coined that term: government should use its fiscal and monetary authority to maintain aggregate effective demand at the full employment level, prevent inflation, and keep interest rates at the level required for the optimal level of investment; if these actions should conflict with the principles of ‘sound finance’ (i.e., result in budget deficits and increase the national debt, etc.), ‘so much the worse for these principles. The government press shall print any money that may be needed for carrying out these rules’ (1941, p. 5).

It was after his move from Kansas City to the New School for Social Research that Lerner laid out the principles of Functional Finance in detail, and by name, in ‘Functional Finance and the Federal Debt’ (1943), probably Lerner’s most famous article, originally published in the New School’s Graduate Faculty journal, *Social Research*, but reprinted numerous times in a variety of collections over many years.

Functional Finance has been subject to a number of misconceptions, e.g., that it promotes big deficits. Functional Finance simply refers to an approach to public finance that sees the federal budget and the management of the national debt as *means* to economic prosperity. This notion needn’t assume any particular *a priori* relation between

government expenditures and revenues or *a priori* most desirable absolute or relative size of the national debt:

The central idea is that government fiscal policy, its spending and taxing, its borrowing and repayment of loans, its issue of new money and its withdrawal of money, shall all be undertaken with an eye only to the *results* of these actions on the economy and not to any established traditional doctrine about what is sound and what is unsound. This principle of judging only by *effects* has been applied in many other fields of human activity, where it is known as the method of science opposed to scholasticism. The principle of judging fiscal measures by the way they work or function in the economy we may call *Functional Finance*...

Government should adjust its rates of expenditure and taxation such that total spending in the economy is neither more nor less than that which is sufficient to purchase the full employment level of output at current prices. If this means there is a deficit, greater borrowing, "printing money", etc., then these things in themselves are neither good nor bad, they are simply the means to the desired ends of full employment and price stability. (Lerner, 1943, p. 354, original emphases)

Thus, Functional Finance does not say anything about what the budget should be prior to economic analysis. If it is concluded that under particular circumstances, a balanced budget describes the best means to economic prosperity, then even a balanced budget is not inconsistent with a functional approach to public finance. 'Sound money' is therefore only inconsistent with Functional Finance if the balanced budget is seen as an *end in itself*, rather than as a *means to an end*. If a balanced budget—or a surplus, to reduce the national debt—is insisted upon, even if it may be shown to have negative economic consequences (or be impossible), then this is not Functional Finance (it is, actually, 'dysfunctional finance'). Likewise, Functional Finance does not stipulate that bigger deficits are 'better' or that deficits are 'good', in and of themselves; what concerns us are the *effects*.

Such an approach has an immediate result that at first glance may appear shocking or surprising: *neither taxing nor government "borrowing" are funding operations*. Decisions concerning taxation are to be made only with regard to the economic effects in terms of the promotion of full employment, price stability, or other economic goals, and not ever because 'the government needs to make money payments' (Lerner, 1943, p. 354). Likewise, 'the government should borrow only if... the effects' of borrowing are desired, for example 'if otherwise the rate of interest would be too low' (Lerner, 1943, p. 355).

These points of view were repeated and elaborated by Lerner in his 1951 book, *The Economics of Employment*:

[T]axes should *never* be imposed for the sake of the tax revenues. It is true that taxation makes money available to the government, but this is not an effect of any importance because money can be made available to the government so much more easily by having some created by the Treasury. (1951, p. 131, original emphasis).

Likewise, ‘borrowing’ is also not a funding operation for Lerner.

What are the purposes of taxation and borrowing, if not to fund government spending? The purpose of taxation for Lerner is its ‘effect on the *public* of influencing their economic behavior’ (Lerner, 1951, p. 131, original emphasis) including, as we will see below, creating a demand for government fiat currency. Like taxation, borrowing is not a funding operation; rather, it is a means of managing reserves and controlling the overnight interest rate when the government runs a budget deficit:

[T]he spending of money...out of deficits keeps on increasing the stock of money [and bank reserves] and this keeps on pushing down the rate of interest. Somehow the government must *prevent* the rate of interest from being pushed down by the additions to the stock of money coming from its own expenditures.... There is an obvious way of doing this. The government can *borrow back* the money it is spending (Lerner, 1951, p. 10-11, original emphases).

Two extraordinary results follow from Lerner’s analysis here. First, the implication is that ‘borrowing’ logically *follows*, rather than *precedes*, government spending. In fact, this analysis questions the accuracy and relevance of the term ‘borrowing’ itself for discussing government bond sales. Second, note that the budget deficit is causing interest rates to *fall*, the exact opposite from what traditional theory has long predicted (i.e., ‘deficits cause high interest rates’).

The role of taxation and borrowing, reserve management and interest rate maintenance will become clearer upon examination of two, less well-known, Lerner contributions, ‘Money as a Creature of the State’ (1947) and his *Encyclopaedia Britannica* entry on ‘Money’ (1946), which place him squarely in the Keynes-Knapp Chartalist school, and which is key to fully understanding the possibility and effectiveness of Functional Finance. The ability of the government to conduct fiscal and monetary policy according to the principles of Functional Finance is made possible by the fact that, as the title of Lerner’s paper states, ‘money [i]s a creature of the state’:

The government—which is what the state means in practice—by virtue of its power to create or destroy money by fiat and its power to take money away from people by taxation, is in a position to keep the rate of spending of the economy at the level required to fill its two great responsibilities, the prevention of depression, and the maintenance of the value of money. (Lerner, 1947, p. 314)

In adopting this view Lerner followed Keynes, who in his *Treatise on Money* accepted the main thrust of Knapp’s ‘State Theory of Money’ (Keynes, 1930, p. 4, p. 6n1; Knapp, 1924). The state has the power not only to tax, but to designate what will suffice to retire tax obligations, that is, what it will accept at its pay offices. By determining public receivability, the state can create a demand for otherwise worthless pieces of paper, leading to general acceptability. The state can issue this currency, and use it to purchase goods and services from the private sector:

The modern state can make anything it chooses generally acceptable as money and thus establish its value quite apart from any connection, even of the most formal kind, with gold or backing of any kind. It is true that a simple declaration

that such and such is money will not do, even if backed by the most convincing constitutional evidence of the state's absolute sovereignty. But if the state is willing to accept the proposed money in the payment of taxes and other obligations to itself the trick is done. Everyone who has obligations to the state will be willing to accept the pieces of paper with which he can settle the obligations, and all other people will be willing to accept those pieces of paper because they know that taxpayers, etc., will accept them in turn. On the other hand if the state should decline to accept some kind of money in payment of obligations to itself, it is difficult to believe that it would retain much of its general acceptability...What this means is that whatever may have been the history of gold, at the present time, in a normally well-working economy, money is a creature of the state. Its general acceptability, which is its all-important attribute, stands or falls by its acceptability by the state. (Lerner, 1947, p. 313)

Thus, a variety of state powers, such as government's ability to tax, declare public receivability, create and destroy money, buy and sell bonds, and administer the prices it pays for goods and services purchased from the private sector, constitute a menu of instruments with which full employment and stability of the value of the currency may be promoted.

The importance of the Lernerian contributions of Functional Finance and 'money as a creature of the state' are hard to overstate. Keynes called this 'second of the two books which you have placed within one cover...very original and grand stuff':

I shall have to try when I get back [to England, from his trip to the U.S.] to hold a seminar for the heads of the Treasury on Functional Finance. It will be hard going—I think I shall ask them to let me hold a seminar for their sons instead, agreeing beforehand that, if I can convince the boys, they will take it from me that it is so! (Colander and Landreth, 1995, pp. 116-7)

Keynes does not trust that the heads of the Treasury can understand, because, as Lerner often noted, 'Functional Finance is seen to run counter to economic principles' (1951, p. 142). Functional Finance, or Keynesian economics taken to its furthest logical conclusions (causing one author to ask, 'Was Keynes a Keynesian or a Lernerian?' [Colander, 1984]), was, in its application to unemployment, Lerner admitted, 'topsy-turvy economics' (1951, pp. 142-5).

But this is no objection at all. Topsy-turvy economics is just what is appropriate for an economy that is suffering from unemployment. An economy suffering from unemployment is an upside-down economy for which *only* a topsy-turvy economic theory is of any use. (1951, pp. 142-43)

By an 'upside-down economy', Lerner means an economy in which strongly held traditional economic principles, such as those regarding thrift and the economical use of scarce resources, do not hold. Lerner noted that when there is unemployment, efficiency becomes inefficient: 'an increase in efficiency in any particular productive process does not result in any increase in efficiency in the economy as a whole...The savings due to

greater technical efficiency merely go to waste in more unemployment' (1951, pp. 143-4). Likewise, when there is unemployment a country has to suffer over its trade balance, because it must worry about rising unemployment stemming from an increase in the value of its imports over the value of exports. Since '[t]he input of the foreign trade industry consists of the effort involved in the manufacture of our exports' and '[t]he output of our foreign trade industry consists of the imports which it yields to us for our use', *exports are a cost and imports are a benefit* (1951, p. 321). Thus, when a nation attempts to cure its unemployment problems by reducing its trade deficit, it is promoting costs and restricting benefits!

One final interesting result of Lerner's Functional Finance is worthy of note here: 'printing money' in and of itself has no effect on the economy whatsoever and therefore should not be considered when conducting macroeconomic analysis and policymaking (contrary to those who claim that printing money is inflationary, for example). For Lerner, there are six (or three pairs of) fiscal instruments of government: taxing and spending, buying and selling, borrowing and lending. Only if the money printed is spent on goods and services or lent through issuing bonds or otherwise given away will there be some economic impact, but these impacts are already covered through the consideration of the six fiscal instruments: 'The printing of money is not an instrument of policy. It is only a servant of those policies, just like printing stationery used in the various government departments' (1944, pp. 312-4):

To sacrifice the prevention of deflation because of shortage of money which could be printed is no more sensible than to refrain from carrying out any other important government action because the necessary paper forms or stationery would have to be printed. (1951, p. 133)

Lerner's promotion of Functional Finance led to his engagement in debates concerning the 'burden' of the national debt and the harmful effects of large and persistent government budget deficits (e.g., 1961a). One point worthy of note here, is that Functional Finance not only opposes the 'deficit hawk' view of government budget deficits as almost always and everywhere harmful (causing high interest rates, inflation, crowding out private spending, and/or a burden on future generations), but also the 'deficit dove' view that if the Federal government kept a capital budget or measured deficits and the national debt differently, they would not look as big. Lerner felt the doves ceded too much to the 'sound money' view, and that this would eventually come back to haunt them, a position that seems quite prescient in light of budgetary politics in the last two decades of the 20th century (Lerner, 1951, pp. 15-6).

During the 1950s, and possibly as early as the late 1940s, Lerner began to become concerned with what he later called 'sellers' inflation' (e.g., 1961b). In his early versions of Functional Finance, inflation was seen as the result of excess aggregate demand, and therefore reducing spending and/or increasing taxation was seen as the cure. But as it became apparent to him that there were other sources of inflation, such as those due to supply-side or cost-push factors, this simple policy for demand-side inflation was no longer sufficient for managing the value of currency. In addition to other types of

inflation, Lerner also began to note that inflation did not begin at true full employment, but well before that point. Thus, he even began to use terms like 'low full employment' and 'high full employment', anticipating the idea of a NAIRU (non-accelerating inflation rate of unemployment) or 'natural' rate of unemployment (Lerner, 1951).

In the face of these developments, Lerner dedicated himself to the study of stagflation, and the evaluation and formulation of various income policies, market anti-inflation plans (or MAPs), and wage-price controls (Lerner and Colander, 1980). These issues preoccupied Lerner for the rest of his career. He suffered a stroke while in Jerusalem in 1980, and although his speech was impaired he was able to continue working until shortly before his death in Florida in 1982. Lerner was survived by his second wife, Daliah, and two children from a previous marriage.

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