Past as Prologue 22-2 introduces Abba Lerner and his theory of functional finance. This bonus material provides additional biographical information and details some of his other contributions to economics.

Abba P. Lerner (1903–1982) was born in Russia and raised in London, where he eventually became a student at the London School of Economics. There he was taught by John R. Hicks, Lionel Robbins, and F. A. Hayek. While attending the London School, Lerner published several important journal articles on microeconomics and helped initiate the Review of Economic Studies. Immediately upon publication of Keynes’s The General Theory in 1936, Lerner recognized its significance, and from that point forward he turned his attention to exploring and extending Keynesian macroeconomics. He came to the United States in 1939 and over the next forty years published numerous articles and books while moving from one university to another. His stops included Columbia, Virginia, Kansas City, Amherst, The New School for Social Research, Roosevelt, Johns Hopkins, Michigan State, University of California at Berkeley, Queens College, and Florida State.

Lerner’s thinking went through several transitions over his lifetime. He entered the London School as a self-described socialist; he left there as a neoclassical economist. Following publication of The General Theory, Lerner became an avowed Keynesian.

Lerner’s writings are extremely diverse. For example, long before Nobel laureates Bertil Ohlin and Paul Samuelson formalized the factor-price equalization theorem of international trade, Lerner had asserted and proved that, under perfectly competitive conditions, the prices of the factors of production in various nations would be equalized through the free trade of products. He was also the first person to establish that economic efficiency depended on the price of products equaling their marginal costs. Lerner, therefore, is credited with providing the first rigorous statement of Pareto optimality. In this same regard, he was a key figure in the development of the theory of market socialism.

In addition, Lerner established an index of monopoly power and advanced a theory of sellers’ inflation. It is to these last two topics that we devote the remainder of our discussion.
THE LERNER INDEX

Lerner stated his index of monopoly power in a 1934 article in the Review of Economic Studies.

\[ L = \frac{P - MC}{P} \]

In this equation, \( P \) is the price of the product, and \( MC \) is the marginal cost of producing it.

The index value varies between 1 and 0, with higher values indicating greater monopoly power. In Cournot’s famous mineral water example (Figure 12-1) in which marginal cost is zero, the Lerner index would be 1. That is, if the price per unit of mineral water is $10 and marginal cost is $0, then \( P - MC \) is also $10, and $10 divided by $10 \( (P) \) is 1.

Under conditions of perfect competition, the Lerner index is 0. In perfect competition, firms are price takers; the price is established in the market. If this price permits firms to make economic profits (those over and above a normal profit), then new enterprises will enter the industry. This entry will increase the supply of the product and drive down the price. Entry will continue until the price of the product falls to the level of marginal cost. At this point, the firms in the industry will be earning only normal profits, and because \( P = MC \), the Lerner index is 0. For example, if both the product price and marginal cost are $5, then $5 \( (P) \) minus $5 \( (MC) \) equals 0, and 0 divided by $5 \( (P) \) equals 0.

Lerner’s index extended the theory of monopoly by focusing on degrees of monopoly power and also by showing how monopoly violates the “price = marginal cost” condition required for achieving economic efficiency.

SELLERS’ INFLATION

Lerner devoted four chapters of his The Economics of Employment (1951) to the problem of controlling inflation. Later, he wrote several articles and two books on the subject: Flation (1972) and MAP: Market Anti-inflation Plan (with David C. Colander in 1980). His early interest in inflation arose out of his notion that there was a range between “low full employment” and “high full employment” over which prices would tend to rise as employment increased. Later, A. W. Phillips confirmed this idea empirically for Great Britain by plotting the now-famous Phillips curve.

According to Lerner, buyers’ inflation (now referred to as demand-pull inflation) occurs when there is too much spending in the economy. Government can control this type of inflation by strictly adhering to the rules of functional finance. But there is also a second type of inflation: sellers’ inflation, or what today we call cost-push inflation. This occurs when the owners of the factors of production make claims on income that exceed the total real value of the output. This type of inflation occurs because of the presence of market power in the setting of wages and prices. The resource sellers who possess market power, such as labor unions and oil cartels, force up resource prices at a rate faster than the growth of resource
productivity, causing the costs of production to rise. Eventually these higher costs produce higher product prices.

Although government can halt sellers’ inflation through restrictive fiscal and monetary policies, these policies will lead to higher than desirable levels of unemployment. In addition, attempts to use functional finance to maintain high levels of employment will aggravate sellers’ inflation. Functional finance, therefore, is not alone sufficient to achieve full employment and price stability simultaneously; some form of incomes policy is needed. Government must institute a policy that will limit the claims on the national income made by resource owners to the existing level of real output. Stated more conventionally, the government must institute a wage and price policy.

Lerner proposed several such policies over the decades. In *The Economics of Employment*, he recommended a plan that would limit the average annual wage increase in the economy to the nation’s annual rate of productivity growth. This idea became the common feature of the wage and price guideposts, controls, and standards established during the 1960s and 1970s.

In the late 1970s Lerner’s attention turned to a market-oriented incomes policy. His goal was to translate “the social harm from the inflationary element in price and wage increases into a private cost that the firm will try to avoid, and to do this through the market mechanism so as to avoid all administrative control or regulation of wages and prices.” The basic concept was to have a government agency issue “anti-inflation credits,” which firms would have to pay to the agency when they increased their prices. The supply of these credits would enable enterprises to increase their prices by an average of some targeted amount, say 2 percent. Firms desiring to raise their prices by more than 2 percent would have to buy credits either from companies that held their price increases below 2 percent or from firms that accumulated additional credits because they reduced their prices. A market for credits, therefore, would emerge. The price per credit would serve both as an incentive to hold price increases below 2 percent and as a penalty on firms that raise prices by more than 2 percent. Employers would increase their resistance to excessive wage demands because, if they granted them, companies would need to buy credits to increase prices and recover their higher costs.

Although receiving considerable attention, Lerner’s proposals for market-oriented incomes policies were dismissed by fellow Keynesians who felt that the plans were impractical, and by monetarists who contended the proposals mistook the *symptoms* of inflation—rising wages and prices as being the *cause* of inflation.

Although many of Lerner’s policies overlooked practical complications, there can be no doubt that his overall contribution to economic thought was significant. In this respect, Tibor Scitovsky has stated, “Abba P. Lerner was one of the most original and imaginative economists of his generation. He initiated more of the concepts, theorems and rules that today constitute our profession’s workaday tools than anyone else.” Although this may be an overstatement, there is little disagreement that Lerner contributed significantly to the development of economic thought.

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Selected Readings

