LERNER'S ECONOMICS OF EMPLOYMENT
A REVIEW

W. S. WOYTINSKY

Economics of Employment has all the qualities of Abba P. Lerner's other writings: its arguments follow each other with the logical consistency of Euclidian theorems; its style is brilliant; complex problems are discussed in simple words. The book's political philosophy—as far as the author's intentions are concerned—is democracy. Moreover, Lerner is a writer of courage. When he arrives at a conclusion which is likely to raise doubts in the reader's mind, he does not try to ingratiate himself but expresses his thought in provocative terms for the reader to accept or reject. If the reader has faith in Lerner's premises, he will accept his conclusions. If he has no faith, his reaction makes no difference to the author.

The volume is neither a treatise nor a popularization of the usual type, but an eloquent and passionate plea for the application of Keynesian economic theory to a policy which Professor Lerner describes as "Functional Finance" (with two capital F's). Professor Lerner stresses that the topic of Economics of Employment is not full employment but employment in general. Actually, as a treatise on employment the book is sketchy and very superficial—it covers only one of the long list of problems related to employment. Its real topic is the fiscal policy for ensuring full employment. It is a typical single-verse sermon, and the verse is: Spend and have employment or, in broader terms, Spend and be happy.

The theoretical part of this volume is pure and undiluted Lord Keynes. Its practical part is pure and undiluted Lerner. Lord Keynes appears here as Allah, and Lerner as his militant Prophet. This comparison is suggested by Lerner's efforts to explain why Functional Finance is not likely to become the center of a religious movement. Indeed, there is something of religious fervor in Lerner's treatment of the Keynesian theory as the key to universal prosperity and happiness.

As an ardent believer, Professor Lerner addresses his ideas to fellow believers, and there is little doubt that they will accept them. However, I would like to bring the book to the attention of non-believers, those who remember the havoc Keynesian ideas caused among American economists in the 1940's and who realize...
the pernicious influence these ideas can exercise on our future economic thinking. For this group of readers, Lerner's book will be very useful: there are few anti-Keynesian works in which the fallacies of Functional Finance and related programs are exposed so clearly as in this apostolic message.

I agree wholeheartedly with Lerner when he denounces the evils of unemployment and stresses the responsibility of the government for stimulating the efficient utilization of the nation's labor force and its industrial capacity. I agree likewise that under certain conditions, similar to those in the 1930's, the growth of unemployment calls for courageous fiscal measures: generous outlays for public works and straight relief, a liberal money policy, relaxation of taxes, deficit spending, and other measures usually described as pump-priming. The controversy begins with the question whether all these measures belong to an emergency program or to an everyday routine.

FULL EMPLOYMENT AND GOVERNMENT SPENDING

As a practical matter, Lerner recognizes that his policy of pumping money into the economic system must stop after a definite level of employment is reached. Thus, if his pumping is successful it must be a temporary measure, exactly as in "priming the pump." The difference between the two policies is in their philosophy.

For Lerner, the maintenance of the flow of purchasing power is a permanent responsibility of the government. He does not advocate keeping the faucet of spending open continuously, but he minimizes the harm and inconveniences of premature and protracted spending, in comparison with those of nonspending when spending—allegedly—could promote full employment.

Although full employment is the ultimate goal of government, Lerner fails to define the concept. He describes it, rather timidly, as the "condition where those who want to work at the prevailing rates of pay can find work without undue difficulty." He distinguishes, however, between frictional and deflationary unemployment and recognizes that the two phenomena call for quite different forms of treatment. But he believes that the concept of "undue difficulty" can be clarified by the statement that "undue difficulty is . . . defined so that full employment is reached at the level where inflation begins."

This raises the question, where does inflation begin? In fact, it never does begin in all economic sectors simultaneously. Inflationary pressures can exist in certain sectors while deflationary forces prevail in others. If the cost-of-living index is considered the yardstick of inflation, the latter can occur in the midst of mass unemployment.

Finally, the prescription that the government must maintain full employment by free spending until inflation begins permits two interpretations. Either the "beginning of inflation" and "full employment" are synonymous, or the government must pump money into circulation until this policy provokes an inflation, independent of its effect on employment. The first interpretation leaves undefined the concepts of full employ-
ment and "undue difficulty"; the second divorces the problem of fiscal policy from that of employment. Either interpretation leaves a sceptical reader with the impression that the goal of Functional Finance ("full employment") is to be kept top-secret. If the reader has patience enough to read the book to the end, he will learn that it is not secret at all. Lerner's idea of "full employment" as an objective of fiscal measures in the United States is simply a condition when not more than six million people are looking for work. That is indeed a very conservative definition. If unemployment of such severity continues for several months, without any sign of improvement, there is an emergency which urgently calls for governmental interference.

One does not need to be an addict of Functional Finance to recognize the government's responsibility in such an emergency. My main criticism of Functional Finance is that, in the event of mass unemployment or depression, a thorough analysis of the situation should be made before any measures are taken. Such an analysis could begin before unemployment reached six millions. Also, some routine measures—such as increase in the outlays for relief and public works—could be started in advance; but different situations can require different measures, and there are no statistical indexes and curves, no algebraic functions and equations, no gadgets which can signal the exact moment when action should begin or stop. It would be a mistake and a dangerous disservice to the community to decide in advance that each rise in unemployment should be met by pouring money into circulation.

In this respect, the philosophy of Functional Finance seems to fall far behind that of its precursor, the "prime-the-pump" policy, which can be boiled down to the statement that world economy in the early 1930's was aggravated by an acute deflation and could not be overcome without courageous antideflationary measures.

**PREDICTION OF NATIONAL INCOME**

With respect to theory, the core of Lerner's argument is in Chapter 5. The author tells the reader who finds this chapter difficult to skip it. On the contrary, I recommend it to the attention of all who are interested in the foundation of the Lerner version of the Keynesian theory.

Automatically operated Functional Finance presupposes an agency that knows what is in store for the nation. There is no place for guesses and judgment in the operation of such an agency. Its decision is irrevocable and final and releases—or stops—automatically the flow of billions of dollars. (Lerner does not say this in as many words, but this seems to be the cornerstone of his program.)

The agency's task is to predict national income, and Lerner shows how such a prediction can be effected. The clue is the knowledge of "how consumption affects income and how income affects consumption." There are "two unknowns and two equations and we can solve them." Leaving investment out of the picture, the first equation is simply:

\[ \text{Income (} J \text{)} = \text{Consumption (} C \text{)} \]

The second equation is the **propensity-to-consume equation**, supposedly:

\[ \text{Consumption (} C \text{)} = \text{the first } 40\text{ billion of income, plus } \frac{2}{5} \text{ of the rest of income.} \]

Thus, the system of two equations with two unknowns (in billions of dollars) is:

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\begin{align*}
(1) & \quad J = C \\
(2) & \quad C = 40 + \frac{2}{5} (J - 40)
\end{align*}
\]

*P. 68.*
The solution is, of course:

\[ J = 40 \]

And the author concludes: "We can see without much difficulty that it is impossible for any income other than 40 billion dollars to satisfy, both, the equality of income to consumption and the propensity to consume which is supposed to rule."\(^5\)

We can see also that the solution is largely independent of equation (2). In fact, the result will be exactly the same if the propensity to consume is described by any one of the following equations:

\[
\begin{align*}
(2, a) & \quad C = 40 + 0.9 (J - 40) \\
(2, b) & \quad C = 40 + 100 (J - 40) \\
(2, c) & \quad C = 40 + 0.01 (J - 40)
\end{align*}
\]

This occurs for the simple reason that $40 billion has been assumed to represent the fully consumed part of the income, and it has been assumed that total income must be equal to total consumption.

It can be proved that Lerner's assumption expressed in equation (2) is not only arbitrary but contrary to historical experience. It implies, indeed, that people in the United States had no savings until the national income reached $40 billion, and that with a national income of some $280 billion we should have annual savings of approximately $80 billion.

As soon as equation (2) is replaced by another more realistic assumption, that people consume 9/10 of income and put aside 1/10, the system of equations will be:

\[
\begin{align*}
(3) & \quad J = C \\
(4) & \quad C = 9/10 J
\end{align*}
\]

a system which has only one solution,

\[ J = 0 \]

In brief, prediction of national income on the basis of algebraic equation fully depends on how these equations are written.

Lerner continues his reasoning by introducing a new element, investment (I), estimated at $10 billion. This provides a system of three equations with three unknowns:

\[
\begin{align*}
(5) & \quad J = C + I \\
(6) & \quad C = 40 + \frac{2}{3} (J - 40) \\
(7) & \quad I = 10
\end{align*}
\]

which gives the solution \[ J = 70 \] billion.

Indeed, the solution is determined in this case by the request that the excess of national income over $40 billion must be equal to one-and-half times its excess over $50 billion. There is, however, not the slightest justification for such a request. If, on the other hand, more realistic assumptions are used, the whole system of prediction collapses. If, for example, future investment is set as a more or less stable percentage of future income, the system becomes either insolvable:

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\begin{align*}
(8) & \quad J = C + I \\
(9) & \quad C = 9/10 J \\
(10) & \quad I = 1/10 J
\end{align*}
\]

or suggests that \[ J = 0 \] as in the following example:

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\begin{align*}
(11) & \quad J = C + I \\
(12) & \quad C = 9/10 J \\
(13) & \quad I = 1/20 J
\end{align*}
\]

Both these systems of equations are at least as defensible as those presented by Lerner. As in the discussion about postwar economic perspectives in the 1940's, Lerner's theory hinges on the postulate of a consumption formula which implies an imminent danger of mass unemployment as a result of under-consumption and oversaving.

National income can be predicted, but
not by the use of algebraic formulas. The forecast should rely on an analysis of current trends in different economic sectors, supported by inquiries about the expectations and investment plans of business and the intentions of consumers. This method cannot provide reliable projections for several years ahead but can give satisfactory results at least for half a year or somewhat more. Moreover, the prognostications should be continuously rechecked on the basis of current information.

Lerner, who stresses the sound sense of his program, avoids this direct approach to the problem: some kind of algebraic magic seems to be essential to his program.

In fact, the program would not be original if it simply recommended high taxes, postponement of public works, and retirement of the public debt in periods of an inflationary boom, and, conversely, relaxation of taxes, expansion of public works, generous welfare measures, and eventual increase in the public debt in times of depression and mass unemployment. Its originality is the assertion that with the aid of special equipment, an agency will be able to foresee the future and manipulate finances on a continuous basis, forestalling undesirable developments. A closer inspection reveals that the agency's entire electronic equipment will consist of an outmoded consumption-function, a device that was tested in the 1940's and proved to be exactly as effective as the crystal ball of a turbaned fortune teller in Atlantic City.

DUAL ROLE OF FUNCTIONAL FINANCE

There is a strange duality in the role Lerner attributes to Functional Finance. Some paragraphs of his book leave the impression that this responsibility of the government must have absolute priority over all other commitments. In another place, however, he explains that Functional Finance does not interfere with other governmental objectives, that it "merely indicates how the government, in addition to doing whatever it may want to do on all other matters, can also prevent inflation and deflation and thus give us full employment." When formulated in this cautious way, the idea seems sound.

Lerner is right when he stresses that our economic system has no automatic devices protecting it against dislocations. During most of the century and a half from 1779 to 1929, this country enjoyed conditions of reasonably full employment, but it also suffered periods of devastating inflationary floods and deflationary droughts. Most people will agree that protecting the community against these destructive forces is an important responsibility of modern government. If the purpose of Functional Finance were to stress this task of the government, few objections could be raised against it.

Functional Finance is not, however, simply a tail attached to the dog of the national budget. It behaves rather like a dog which looks on all other budgetary operations as the tail he can wag at his desire. Lerner accepts taxes only as a means for reducing the community's purchasing power, never as a means for providing governmental revenues. He professes that the simplest and the only logical way to obtain money for a government is to print it. This theory is not new, of course. Lerner has not added a single new argument in its support and has not even tried to

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answer the objections this theory provokes.

The first and most obvious objection—conforming with the idea of Functional Finance as a supplement to the ordinary budget—is that, as long as inflationary and deflationary forces are in balance with each other, the government’s revenues must be likewise in balance with outlays. The balanced budget is the simplest way for ensuring the desired equilibrium. It implies that each dollar the government spends for its operation must be extracted from national income by means of taxation. Lerner ridicules this procedure, but its only alternative is a financial system in which the government prints all the money it needs and—as a completely separate operation—destroys an equal amount of the purchasing power of individuals. The latter purpose could be achieved, theoretically, by confiscation, or demolition of houses, or setting fire to selected properties. Few people will agree that such measures make more sense than the orthodox procedure.

Lerner’s argument would win if it were free from such iconoclastic outbursts as the assertion that “taxes should never (Lerner’s italics) be imposed for the sake of the tax revenues,” that money “could be provided by an appropriate printing job,” etc.

**OBJECTIONS TO FUNCTIONAL FINANCE**

At some places Lerner’s statements are puzzling. After having elaborated his solution of the problem of unemployment—including the equations appraised above—he turns to the question why Functional Finance has not been accepted by the world. Here we quote:

The commonest immediate reaction of anyone who for the first time grasps the principles of Functional Finance is to ask how is it that the government does not carry out such an obviously intelligent policy which is in the interests of everybody. Immediately following this question, however, comes the attempt to answer it by saying that the argument must be wrong although it sounds plausible and no flaw is apparent.7

One would expect a rather different immediate reaction from those who grasp the theory developed by Professor Lerner: first, surprise in the face of this array of arbitrary assumptions and obviously indefensible conclusions; then doubt whether the first impression is correct; and, finally, the admission that probably the author has some other and better arguments in support of his faith.

One would think, for example, of explaining the extravagancies of Functional Finance by applying it to a particular, exceptional situation such as the early 1930’s. Examined against the background of that upside-down economy, the topsy-turvy finance recommended by Lerner begins to make sense. Lerner does not ask, however, for such condescending criticism. He wishes to have his theory accepted with all its implications or rejected, and objects indignantly to the idea that Functional Finance is an outgrowth of the great depression.

For Lerner, his message is the eternal truth, and with more courage than mod-

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7 P. 142.
esty he explores the sources of "resistances" to it. These, he finds, are "almost entirely based upon misunderstandings of the nature of the disease and on the nature of the remedies proposed." He misses completely the real objections: that unemployment can be accounted for by different factors; that not all of such factors can be eliminated by the magic of fiscal measures; that a premature interference by the government can be as harmful for full employment as the do-nothing policy; that the public has no confidence in the perspicacity and judgment of those governmental economists who are most eager to try their hand in manipulating money, prices, and employment; that the policy of printing money has been tested many times with such telling results that new experiments are not necessary; that experience has shown that, ultimately, printing money is the most expensive way of getting it; that Functional Finance would not only impose new responsibilities on the government but also invest it with tremendous power in economic affairs; that there is danger that this would make the whole economy a football of politics; that, far from ensuring full employment, this policy would create a general instability; that, even if it eliminates the economic ups and downs, the nation would pay for the resulting full employment with economic stagnation and increasing poverty.

Lerner has failed to answer these objections. He believes optimistically that all "resistances" to his doctrine will be overcome by education.

**WAGE POLICY**

One of the most interesting parts of Lerner's book deals with wage policy as a vehicle for raising the low full-employment level (characterized by about six million workers out of work) to the high full-employment level (with frictional unemployment reduced to two million). Lerner's general idea is to break the excessive bargaining power of labor unions, without prejudice to the maximum possible over-all rise in real wages, and to ensure a more equitable distribution of over-all gains among different groups of workers. The plan is presented in great detail, although some crucial questions are left open.

The desirable average rise in wage rates is set at 3 percent per annum, but actual gains of different occupations in different industries are supposed to range between 0 and 6 percent. The rate of gain for each group of workers will be determined by the indexes of the "relative attractiveness" of the respective jobs. Such an index is "provided by the ratio between the number of people who are qualified and ready to work in the occupation but have not been able to get a job there and the number of people actually employed in the occupation."

As he sees it, the index of attractiveness is obtained by taking the total number of workers who are qualified for and want to work in the occupation at the given wage and employment conditions but who are not working there now, whether they are working elsewhere or not; then taking the number of workers actually employed in the occupation; and then dividing the first number by the second. There will be no increase in wage rates where the index of attractiveness is more than twice the national average. Where the index ranges between half and double the national average, the raise will be of 3 percent per annum. Where the index is less than half the

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8 P. 185.

9 P. 214.
average, wage rates will be increased 6 percent.\textsuperscript{10}

The indexes of attractiveness will be determined by a registration of workers expressing their willingness to move from where they consider the wages and working conditions less satisfactory to where they consider these more satisfactory.\textsuperscript{11} Since registration is purely voluntary, under this plan "the workers themselves and not any officials of any organization that claims to represent them" will decide the changes in wages.

This plan raises serious apprehensions. The expression of willingness to take a job under existing wage conditions does not necessarily prove that the individual is qualified for the job. What such kind of registration would measure is the ambition of individuals rather than the fairness of the existing wage rates.

It is not very clear how the proposed system is supposed to work. Obviously, strikes must be outlawed, labor unions prohibited from demanding any raise above the prescribed rate, and employers forbidden to meet such demands from individual workers. Actually, the system presumes a complete regimentation of wages. Since there will be no agency to supervise and operate the system, no exceptions from the prescribed rules can be permitted. The enforcement of such a system would be as difficult as a total regimentation of the labor market and the direct assignment of jobs and wages to each individual by the government. In brief, the current cost of strikes and industrial disputes appears trivial in comparison with the price this nation would pay for the streamlined wage structure described.

The plan is typical of Lerner's thinking. With a laudable purpose in view, he picks up a few assumptions which may be correct or false and deduces from them one thesis after another without visible concern about the environment, reality, or experience.

Elaboration of economic theories in the rarefied air of abstraction, without regard for historical background and human psychology, is often described as building economic models. Lerner is an expert model builder, and his book is an instructive example—a model of models, I would say. There is little chance that his plans will influence the financial and wage policy in the United States, but his book is fresh and stimulating. Teachers and students of economics, whether they are inclined to agree with the author or this reviewer, will not regret the hours they spend reading Lerner's new book.

\textsuperscript{10} P. 215.
\textsuperscript{11} P. 216.

\section*{Reply}

In his lengthy review of my book, Dr. Woytinsky has paid me the compliment of treating a number of preliminary suggestions for the development of a theory as if they were fully developed policies for immediate application. As such they naturally do not qualify. This is particularly true of the suggestions for the development of a democratic technique for preventing wage inflation in full employment.

A similar exaggeration of my claims underlies his criticism of my use of the consumption function. The formula he quotes is merely part of a simplified model of a free enterprise economy. It is nowhere put forward as a realistic description of the United States or as