# A Historical Analysis of the "Crowding Out" of Private Expenditures by Fiscal Policy Actions

| | |
|---|---|
| **Authors** | Roger W. Spencer, and William P. Yohe |
| **Working Paper Number** | 1971-013A |
| **Creation Date** | January 1971 |
| **Citable Link** | https://doi.org/10.20955/wp.1971.013 |
| **Suggested Citation** | Spencer, R.W., Yohe, W.P., 1971; A Historical Analysis of the "Crowding Out" of Private Expenditures by Fiscal Policy Actions, Federal Reserve Bank of St. Louis Working Paper 1971-013. URL https://doi.org/10.20955/wp.1971.013 |

Working Paper No. 13

# A Historical Analysis of the "Crowding Out" of Private Expenditures by Fiscal Policy Actions


Roger W. Spencer
William P. Yohe


January 31, 1971


Roger W. Spencer is an Economist at the Federal Reserve Bank of St. Louis. William P. Yohe is Professor of Economics at Duke University. Professor Yohe began this paper while at this Bank as a visiting professor.

# A HISTORICAL ANALYSIS OF THE 'CROWDING OUT' OF PRIVATE EXPENDITURES BY FISCAL POLICY ACTIONS

by Roger W. Spencer and William P. Yohe

> As Voltaire said, an incantation will destroy a flock of sheep if it is accompanied by a sufficient dose of arsenic.
>
> Alfred Marshall[1/]

Fiscal policies have dominated economic stabilization theory and practice over the past three decades. Keynes and his interpreters share the responsibility for this development. Recently, however, the view that Government spending and taxing policies are not the dominant forces influencing economic activity has been revived. The thesis that Government expenditures, when unaccompanied by monetary expansion, "crowd out" a significant volume of private spending was thoroughly reviewed in a recent article.[2/] This working paper is a historical supplement to that article.

Elements of the crowding-out thesis may be found in the writings of classical and neo-classical economists, as well as in the writings of Keynes himself. This paper first traces the crowding-out views of such classical economists as Adam Smith, David Ricardo and John Stuart Mill. Next, the relevant observations of other economic (and political) figures

---

1/ "Memoranda and Evidence Before the Gold and Silver Commission", in Alfred Marshall, Official Papers (London: Macmillan and Company, 1926), p. 40.

2/ Roger W. Spencer and William P. Yohe, "The 'Crowding Out' of Private Expenditures by Fiscal Policy Actions", Federal Reserve Bank of St. Louis Review, October 1970.

from the period of the classical economists down to the time of Keynes are given. Finally, the evolution of Keynes' thinking on the fiscal displacement issue is discussed.

## <u>The Classical Economists' Views on Fiscal "Crowding Out"</u>

The doctrine that Government expenditures tend to displace, or "crowd out," private spending may be traced at least as far as Adam Smith's <u>Wealth of Nations</u> in economic literature. Some passages describing the crowding-out phenomenon seem almost in answer to Keynes' advocacy of the benefits of Government spending:

> The public funds of the different indebted nations of Europe, particularly those of England, have by one author been represented as the accumulation of a great capital superadded to the other capital of the country, by means of which its trade is extended, its manufacturers multiplied, and its land cultivated and improved much beyond what they could have been by means of that other capital only. He does not consider that the capital which the first creditors of the public advanced to the government, was, from the moment in which they advanced it, a certain portion of the annual produce turned away from serving in the function of a capital, to serve in that of a revenue; from maintaining productive labourers to maintain unproductive ones, and to be spent and wasted, generally in the course of the year, without even the hope of any future reproduction.3/

Elements of Smith the philosopher, as well as Smith the economist, are found in his aversion to Government spending,

---

3/ Adam Smith, <u>Wealth of Nations</u> (New York: Random House, Inc., 1937), p. 877. Smith's attack on the mercantilist thought of his time would naturally apply to much of Keynesian economics.

whether financed by taxation, borrowing from the public, or money creation. Taxation provided for the transfer of the proceeds of unproductive labor from one unproductive employment to another. Moreover, taxation might have the harmful effects of diminishing the landlord's ability to improve his land and induce the owner of capital to remove it from the country. "Funding," or borrowing, involved the "destruction of some capital which had before existed in the country; by the perversion of some portion of the annual produce which had before been destined for the maintenance of productive labor, towards that of unproductive labour."4/

Borrowing permitted the public to save more during a war, but if wars could not be financed by borrowing, they "would in general be more speedily concluded, and less wantonly undertaken." 5/ Moreover, repaying the debt, whether owed to a nation's own citizens or foreigners, greatly burdened ordinary peace-time revenue, especially in view of the interest payments incurred. Smith foresaw only inevitable decline and/or bankruptcy for countries resorting to excessive debt funding.

> The practice of funding has gradually enfeebled every state which has adopted it. ...When national debts have once been accumulated to a certain degree, there is scarce, I believe, a single instance of their having been fairly and completely paid. The liberation of the public revenue, if it has

---

4/ Ibid., p. 878.

5/ Ibid., p. 878.

> ever been brought about at all, has always been brought about by bankruptcy; sometimes by an avowed one, but always by a real one, though frequently by a pretended payment.6/

One of Smith's maxims, that saving is spending, was the basis for the later classical economists' stand against the view that Government spending was necessary to guarantee full employment. The "saving is spending" argument was later developed by the French economist J. B. Say into the "law" that "supply creates its own demand." Say's Law was defended by David Ricardo and John Stuart Mill against the "Keynesians" of the early 19th century - Lauderdale, Spence, Torens, Blake, and Malthus.

## Say's Law and the Crowding-Out Effect

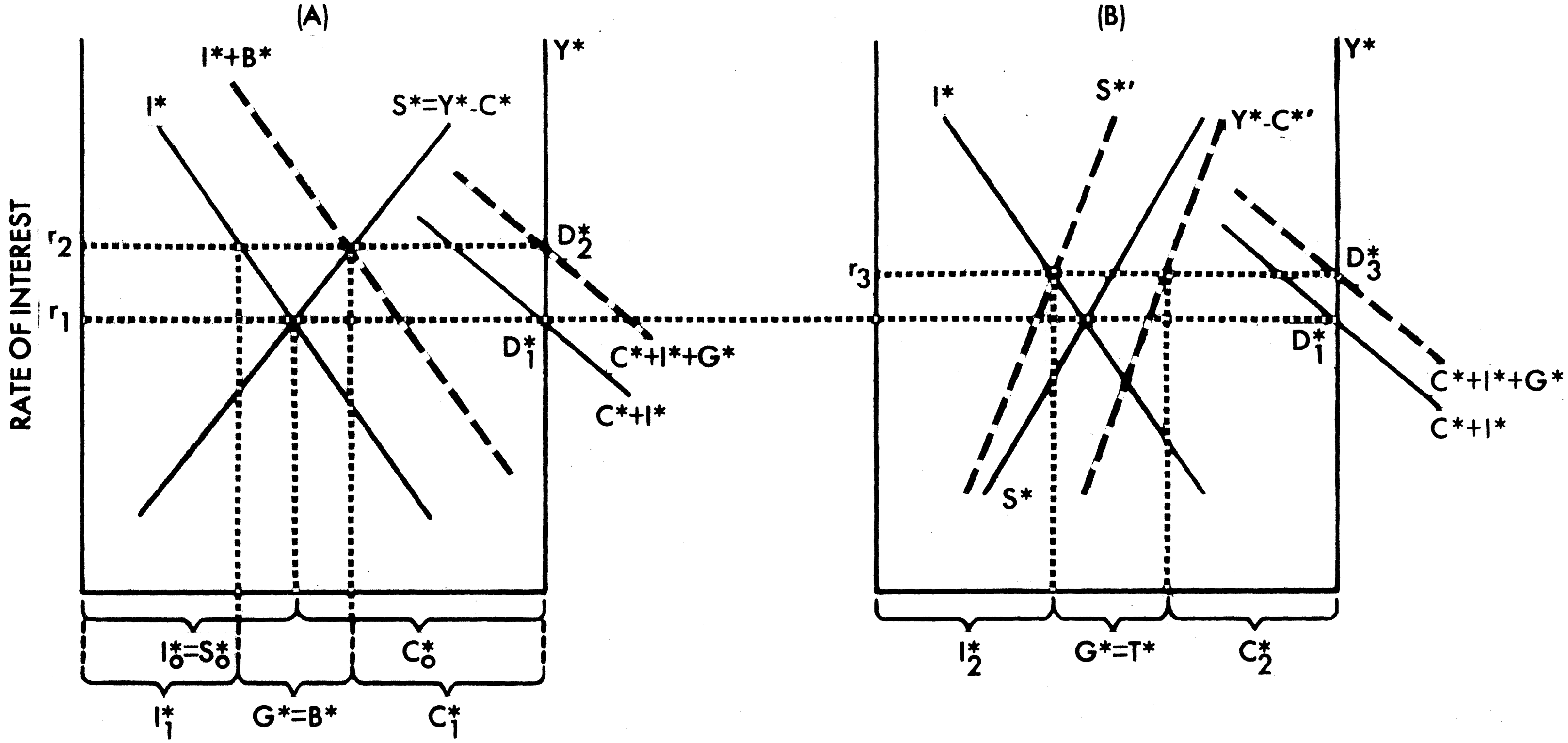
Figure 1 illustrates the operation of Say's Law. Assume that output and expenditures are expressed entirely in "real" terms. The level of real output, Y*, is determined mainly by the economy's production function and the equilibrium level of employment in competitive labor markets. Both part A and part B of the figure depict the economy's capital market, that is, the market whose relative price (the rate of interest) adjusts to allocate resources between present consumption, future consumption (via saving and investment), and any competitors with investment for resources not demanded for present consumption (that is, Government spending). The schedule

---

6/ *Ibid.*, pp. 881-2.

Figure I

## Crowding Out in a Say's Law Economy




SAVING, DEBT ISSUANCE, TOTAL SPENDING AND ITS COMPONENTS

Deficit financed by borrowing from the nonbank public.

SAVING, TAX REVENUE, TOTAL SPENDING AND ITS COMPONENTS

Deficit financed by increased taxes.

Prepared by Federal Reserve Bank of St. Louis labeled I* represents the demand for funds to finance new investment goods at various interest rates. Its downward slope with respect to interest rates reflects essentially the diminishing marginal productivity of additional capital goods. With other factors of production constant, increments to the stock of capital goods are subject to diminishing returns.

The public's desired saving at various interest rates, S*, is upward sloping, reflecting the fact that to induce the public to save more (consume less) requires continuously higher interest returns, in order to keep in balance the satisfactions to be gained from the increments to future consumption which the current saving provides. The amount the public intends to spend for consumption at each rate of interest, C*, is simply the horizontal distance between the output (real income) line and the saving function. If the Y* line were to shift to the right, both saving and consumption would also be expected to shift in the same direction. The schedule for total real demand, in the absence of Government spending, has been depicted as the sum of C* + I* in the left-hand portion of the figure.

At interest rate $r_1$, investment and saving desires are equal, and total demand, ($D_1^*$) necessarily lies on the aggregate supply line, (Y*). At higher or lower rates of interest, forces are set in motion which tend to return the system to equilibrium. At a lower rate of interest, businessmen would desire to spend for investment more than the public desires to save. If saving is the only source of funds for financing investment (that is, if banks are unable to create new money and credit, and holders of old money balances do not elect to channel some of their funds to the capital market), then the excess demand for saving bids interest rates up toward $r_1$. Similarly, there would be excess saving above $r_1$ with resultant downward pressure on interest rates. Alternatively, at any rate below $r_1$ aggregate demand (C* + I*) would exceed aggregate supply (Y*), but the excess would be removed as the interest rate rose to $r_1$. Above $r_1$, aggregate demand would fall short of aggregate supply, but the downward movement of the interest rate would bring about equality between <u>effective</u> demand (actual spending, $D_1^*$) and supply.

<u>Bond-Financed "Crowding Out"</u>

Now we introduce Government spending and its financing either through borrowing from the public or taxation. In Figure 1(A) the Government spending (G*) is financed by borrowing (B*) which adds to the demand for investment in competing for funds supplied by savers. With only intended saving to finance investment and the deficit (by assumption the banking system cannot accommodate the excess demand for funds at the original interest rate), the interest rate will tend to rise to $r_2$. Total spending (effective demand), $D_2^*$, is still the same, because the interest rate increase has caused private investment plus consumption to decline by the same amount as the deficit-financed expenditures have added to demand. Thus, complete crowding out occurs when the interest rate (along with other relative prices) adjusts to maintain equilibrium in the capital market.

## Tax-Financed "Crowding Out"

The increased Government expenditures can also be financed by a tax on real income. For simplicity, assume that the tax affects only consumption and saving and not investment demand.[7/] Further, assume that at high interest rates the tax falls more heavily on saving than consumption, and the reverse at low interest rates. Thus, in Figure 1(B), the saving function shifts leftward from S* to S*', and the consumption function rightward to the difference between the Y* line and the Y*-C*' line, with the tax yield, T*, equal to the horizontal distance between these new lines.

In this case, given the earlier assumptions, the interest rate will rise from $r_1$ to $r_3$, and aggregate demand will be unchanged in total but will be reallocated in favor of Government spending at the cost of investment and consumption. Thus, the balanced-budget multiplier effect on spending is zero, that is, the tax-financed increase in Government expenditures crowds out an equal amount of private expenditures because of the adjustment in interest rates and the impact of the tax on consumption and saving.

---

7/ Presumably, the net yield from investment and the net cost of borrowing (with interest deductible from income in computing the tax) would both be reduced by the rate of the tax. See R. A. Musgrave, <u>The Theory of Public Finance</u> (New York: McGraw-Hill Company, Inc., 1959), p. 458.

## Other Classical Economists' Views on Fiscal Crowding Out

Adam Smith had catalogued a large number of the objections to Government spending, but these were not defended equally by his successors. J. B. Say, for example, was concerned about both the initial resource transfer from the public and the subsequent interest payments. "For, unless the principal be spent upon objects of permanent public benefit, as on roads, canals, or the like, it were better for the public, that the capital should remain inactive, or concealed; since, if the public lost the use of it, at least it would not have to pay interest."8/

Ricardo, however, took the view that the burden of a national debt is not the interest, but the loss of original capital:

> When, for the expenses of a year's war, twenty millions are raised by means of a loan, it is the twenty millions which are withdrawn from the productive capital of the nation. The million per annum which is raised by taxes to pay the interest of this loan, is merely transferred from those who pay it to those who receive it, from the contributor to the tax, to the national creditor. The real expense is the twenty millions, and not the interest which must be paid for it.9/

John Stuart Mill was not as doctrinaire in his rejection of any beneficial aspect to fiscal stabilization policy. Unlike Ricardo, he felt there had been an increase in wealth during the Napoleonic wars due to increased Government

---

8/ Say is quoted by Jesse Burkhead, in "The Balanced Budget," Quarterly Journal of Economics (May 1954), p. 195.

9/ Ibid., p. 196.

expenditures. He also saw the unlikely possibility of excess capacity developing in the economy, but for the most part, Mill maintained that a decision to save created an equivalent amount of ex post investment, and that, therefore, it was virtually impossible that saving could lead to overproduction.[10/] The test of whether Government spending was pressing on private investment, according to Mill, was to determine if the interest rate was rising. Generally, however, Mill agreed with Ricardo that Government borrowing involved a reduction in private spending, but he couched his argument in terms of a reduction in the laborers' "wages fund." Mill believed that "public borrowing, which involves a draft on funds engaged in production, or about to be so employed, is equivalent to taking the amounts borrowed from the wages of the laboring classes."[11/]

Others, such as Tooke and Barton,[12/] also espoused the fiscal displacement view in the first half of the 19th century, but added little new to the doctrine as established by the major classical economists. Some of the classicists'

---

10/ Malthus, credited by Keynes as being the first "underconsumptionist", held the classical view regarding Government spending during certain periods, but was far more skeptical than Mill (and the classical economists) about the "saving is spending" doctrine. See B. A. Corry, "The Theory of the Economic Effects of Government Expenditures in English Classical Political Economy", Economica (February 1958), pp. 38-9.

11/ Lewis H. Kimmel, Federal Budget and Fiscal Policy 1789-1958 (Washington, D.C.: The Brookings Institution, 1959), p. 45.

12/ See Corry, p. 45.

views toward budget financing and debt have been summarized by Burkhead as follows:

> 1. Government loan finance withdraws funds from productive private employment.... 2. Deficits are less painful than current taxes. Unbalanced budgets therefore expand governmental activity and invite irresponsible governmental action.... 3. Government borrowing makes future financing more difficult by increasing the proportion of the budget which must go for fixed charges and by increasing the amount of taxes which must be paid to finance the transfer of interest on the debt.... 4. Loan finance is costly.... 5. Unbalanced budgets lead to currency deterioration. 6. Unbalanced budgets provide a guide for the transfer of resources from the private to the public sector.13/

## Crowding-Out Views from the Classical Economists to Keynes

For the most part, we have discussed the crowding-out arguments dealing with the economic rather than social implications of fiscal policy actions. No value judgments, from the point of view of economic stabilization goals, are entertained in the determination of whether Government spending displaces or supplements private spending. The question of whether Government spending *should* be increased to bring about income redistribution or some other social goal is not a part of the crowding-out effect in the stabilization context.

Social and moral issues, however, have long been intertwined with economic assessments of the optimal role for

---

13/ Burkhead, pp. 203-06.

Goverment policies. Adam Smith's employment of the productive versus unproductive labor concept is a good example.[14/] It is possible to accept Smith's argument against Government borrowing (displacing the private accumulation of capital) and reject his "productivity" arguments. John McVickar, one of the first American economists, could (in agreement with Smith) write that the permanent effect of Government borrowing "is to cripple the energies of the nation," while stating that "The invidious destinction ... between the various classes of the community by arranging them as productive and unproductive laborers, is one of the narrow and imperfect views which is justly discarded in the liberal system of Political Economy."[15/]

Throughout much of the period from the early 19th century to the Keynesian era, Government spending was advocated or opposed on moral and social grounds. The idea that an individual should not spend more than his income was often applied to Governmental bodies. "Debt" and "thrift," whether in reference to individuals or Governments, had stronger moral overtones than presently.

---

14/ Productivity of the Government sector remains a controversial issue, whether in reference to the economic accounting practices employed in the national income accounts or political references to the "value" of certain Government purchases of goods and services such as foreign aid.

15/ John McVickar, Outlines of Political Economy (1825), cited in Kimmel, pp. 47-8.

Some public figures were able to offer both economic (crowding-out) and noneconomic rationale for their fiscal programs. Lewis Kimmel notes that:

> To Andrew Jackson (1829 - 1837) a public debt represented an economic burden, as well as a fiscal one. When he took office, the financial position of the government and prevailing trends suggested that the federal debt would soon be extinguished. After this goal is reached, 'our population will be relieved from a considerable portion of its present burthens, and will find not only new motives to patriotic affection, but additional means for the display of individual enterprise.'
>
> The nature of the economic burden was spelled out by Samuel D. Ingham, Secretary of the Treasury. Discussing the impending extinguishment of the debt, he observed that the 'interest is now paid to capitalists out of the profits of labor; not only will this labor be released from the burden, but the capital, thus thrown out of an unproductive, will seek a productive employment; giving thereby a new impetus to enterprise in agriculture, the arts, comcomerce, and navigation, at a lower charge for interest than before.'16/

Those public figures and economists defending Government spending in the approximate hundred-year period ending with The General Theory rarely endorsed Government expenditures on the grounds that such actions would strongly stimulate private spending. Malthus had suggested such a possibility, as had others in the early 19th century, but not until Keynes were fiscal stabilization arguments vigorously revived.

---

16/ Kimmel, p. 19.

On the other hand, a number of economists, in the years immediately preceding the ascendance of Keynes, adopted the view that increased Government spending tended to crowd-out private expenditures. A. C. Pigou, an English neo-classical economist frequently cited in The General Theory, wrote that:

> *Prima facie*, when revenue is collected by direct taxes and devoted by government authorities either to nontransfer (income-generating) expenditure or to transfer expenditure, aggregate money income is the same as it would have been if this two-sided act of public finance had not taken place ... [;] and, *Prima facie*, the same thing is true when the money required by government authorities is raised by loans from the public....17/

---

17/ A. C. Pigou, A Study in Public Finance (London: Macmillan and Company, 1928, quote taken from 3rd edition, 1947), pp. 21-2. Pigou's crowding-out views were only slightly altered after the publication of The General Theory:

> It must always be borne in mind that investment made whether by the State itself or under the influence of State bounties, if it were undertaken in fields where private investors were accustomed to operate, would entail a falling-off of investment by them; and this reaction *might* be carried so far that aggregate investment was hardly increased at all...
>
> It must be understood, however, that State action of this character, if it is financed by taking in taxes money that private persons would otherwise have themselves devoted either to investment or to the purchase of consumption goods, will not accomplish its purpose. It must be accompanied by the creation of new money, mainly, we may presume, in the form of bank credit.

Keynes's General Theory: A Retrospective View (London: Macmillan & Co., 1950), pp. 58-9.

Irving Fisher regarded large-scale debt issuance, whether by Government or private enterprise, to be ultimately contractionary, not stimulative.

> Probably no economist of his era saw more clearly than Fisher the role of debts, both public and private, in our society. At the same time, he was keenly aware of the dangers inherent in an unbalanced or top-heavy debt structure. 'Excessive debts sooner or later precipitate excessive liquidation. Thus are booms the cause of depressions'.18/

Fred M. Taylor, who published one of the most popular basic economic textbooks in the 1920's, argued that total demand may be deficient in the short run and could be appropriately augmented by Government expenditure, but "increasing governmental expenditures ... in ordinary times ... could do nothing more than deflect demand from some lines of production to other lines of production."19/

Crowding-out influences are also evident in the over-investment theories which were much in vogue in the 1920's and 30's. These theories centered on a view of business cycles founded on Wicksell's market rate-normal (equilibrium) rate

---

18/ Kimmel, p. 130. See Irving Fisher, Booms and Depressions (London: Allen and Unwin, 1933). For a modern treatment of the debt-deflation theory of business cycles, see Hyman P. Minsky, "Financial Instability Revisited: The Economics of Disaster," paper prepared for the Steering Committee for the Fundamental Reappraisal of the Discount Mechanism Appointed by the Board of Governors of the Federal Reserve System.

19/ Fred M. Taylor, Principles of Economics, 9th edition (New York: Ronald Press, 1925), p. 203.

framework.[20/] The basic concept was as follows: (1) an increase in the demand for business credit would raise the normal rate (the rate at which the demand for loan capital just equals the supply of saving) above the actual market rate of interest; (2) banks might finance the excess demand for investment at the old market rate by increasing money and credit; (3) this action would permit investors to compete (with the consumer) more vigorously for goods and services, thereby driving up prices. The increased investment spending produced a channeling of resources away from consumer goods into capital goods production.[21/] Because there is a lag between the translation of the increased investment into increased income, prices rise more rapidly than income, thereby curtailing real consumption and "forcing" consumers to save. The "forced saving" limits consumption and facilitates the transfer of even more resources into the production of capital goods.

During the delay between business sector expansion and income growth, consumer and business spending are <u>not</u> complementary, since business spending has "crowded out" some portion of real consumption which would otherwise have

---

20/ See William P. Yohe and Denis S. Karnosky, "Interest Rates and Price Level Changes, 1952-69," Federal Reserve Bank of St. Louis <u>Review</u>, December 1969, pp. 31-2.

21/ This summary is derived from Gottfried Habeler, <u>Prosperity and Depression</u> (Geneva: League of Nations, 1938), Chapter 3.

taken place.[22/] The inflation, which overlaps some part of the "crowding out" period, continues until the source of excess demand is removed by curtailment of bank credit, permitting the market rate of interest to rise to the normal rate. Over-investment, which occurred at the expense of consumer spending during the upswing of the business cycle, is reversed in the downswing due to the excess capacity originally created in the face of constrained consumer demand.

The over-investment theory might apply as well to the consumer or Government sector, if bank credit were to be

---

22/ The lag could be of considerable length if bank credit is extended to the business sector at an accelerating (rather than a constant) rate.

Richard Cantillon, one of a group of French economists known as the Physiocrats, formulated a "forced saving" type of crowding-out thesis even before the Utilitarian Jeremy Bentham (whom Keynes credited with advancing the notion of forced saving). Cantillon (writing between 1730 and 1734) maintained that an autonomous increase in money (gold or silver) would lead to a rise in prices because those receiving the money increase would "lend or spend" it. Those who did not directly share in the increase in the newly mined gold or silver would be able to buy less because of the higher prices.

"All this increase of expense ... diminishes of necessity the share of the other inhabitants of the state who do not participate at first in the wealth of the mines in question." Those whose consumption would be most likely to be crowded out were "the landowners, during the term of their leases, then their domestic servants and all the workmen or fixed wage earners who support their families on their wages." From D. Vickers, Studies in the Theory of Money 1690-1776 (Philadelphia: Chilton Company, 1959), p. 208.

allocated to one or the other rather than the business community.23/ In other words, insofar as the basic theory is valid, consumer spending, derived from credit which might have been extended to the business community, could "crowd out" spending of the two competing sectors.24/ The Government sector, according to the same theory, could also generate inflationary pressures and a transfer of resources when financed by bank credit. If an (unanticipated) inflation does occur - for whatever reason - the Government, like any other borrower, profits by repaying the debt in cheaper dollars.

Hayek compared increased Government spending with the maleffects of increased consumer spending in that both tend to shorten the round-about process of production. Additional purchasing power granted consumers or Governments would increase the ratio of spending to saving, cause a substitution of labor for capital in the production process, and create an unsustainable boom. Lest the Hayekian theories appear implausible or unrealistic, it must be pointed out that J. R. Hicks noted:

> "...it is hardly remembered that there was a time when the new theories of Hayek were the principal rival of the new theories of Keynes...
>
> It is in its application to deflationary slumps that the Hayek theory

---

23/ Bank credit was far more likely to be extended to business, not consumer or Government, borrowers during the period in which the over-investment theory was popular.

24/ This analysis abstracts from capital/output and capital/labor relationships.

> is at its worst; and it is a terrible fact that it was in just such conditions - in 1931-2 - that it was first propounded. In such conditions its diagnosis was wrong; and its prescription could not have been worse. But because it was wrong then, it does not follow that it must always be wrong. It is possible that there may be conditions to which it is appropriate; and in these days (in 1967) one may not have to look very far before one finds them."25/

## Early Views of Keynes on Fiscal "Crowding-Out"

Keynes, like a number of other economists in the 1920's and early 1930's, held the view that increased public expenditures, financed through monetary expansion, may stimulate a lagging economy.26/ Even the Chicago School economists of the late 1920's and early 1930's (apparently with Henry Simons' doubtful support) recommended increased public expenditures financed "without resort to taxes on commodities or transactions."27/

---

25/ Sir John R. Hicks, Critical Essays in Monetary Theory (Oxford: Clarendon Press, 1967), p. 203, 214.

26/ See, for example, Fredric B. Garver and Alvin H. Hansen, Principles of Economics (Boston and New York: Ginn and Company, 1928), p. 399. "It is especially desirable that these public works should be financed out of additional bank loans so that the monetary purchasing power of the community may be increased."

27/ See J. Ronnie Davis, "Chicago Economists, Deficit Budgets and the Early 1930's," American Economic Review, (June 1968), p. 478. Simons' skepticism about the alleged benefits of Government expansion may be found in his 1942 Journal of Political Economy critique of "Hansen on Fiscal Policy" (pp. 172-4).

Keynes first espoused the public works spending idea in 1924, that is, public spending on loan account.[28/] In 1929 he was a strong supporter of Lloyd George's proposal to reduce unemployment in England through public works spending. The

---

27/ (Cont'd) "Hansen urges us to go on, borrowing and spending Governmentally the redundant savings which private business fails to absorb. A more conservative view would hold that, with easy and abundant money, fiscal measures have done their bit and cannot wisely be relied upon further. ...Given cheap money we should work out our minority and monopoly problems within the framework of general price stability, avoiding that dangerously easy solution of *displacing private by governmental investment* and avoiding debt increase like the plague....

It [Hansen's over-all scheme for governmental absorption of savings] promises a promiscuous spreading of governmental activities which, missing areas where large or complete political control is clearly indicated, gets the government involved in a mass of miscellaneous undertakings for which it has little competence and impairs or inhibits enterprise in many areas where competitive control is most appropriate. Moreover, a progressive society, in which only governmental enterprise can expand, will surely *lose its complement of private business* from sheer atrophy or stagnation." (Italics added)

Simons thought that financing government expenditures by borrowing from the public was not expansionary policy, but *deflationary*. "Against this view [Hansen's preference for borrowing from the public rather than taxation which he thought less expansionary] I should argue that there is never any excuse for borrowing save to *prevent* expansion. Borrowing is a means for displacing money (deposits) with less effective money-substitutes (consols). If we want expansion, the way to get it is by non-interest-bearing issues-exchanging million dollar bills for central bank-deposits, if one must think in terms of an anomalous separation between central banks and treasuries. Borrowing has little place in sound policy, save as temporary, temporizing means for checking incipient inflation and movements until taxation-expenditure adjustments can be made and for avoiding sharp taxation adjustments to quite temporary surges of spending."

28/ See Roy F. Harrod, *The Life of John Maynard Keynes* (New York: Harcourt, Brace and Company, 1951), p. 441, and *Nation and Athenaeum*, June 7, 1924.

English Treasury in the late 1920's was opposed to public works spending financed by borrowing from the public on the grounds that, with a fixed amount of savings in the country, Governmental borrowing could only displace private investment.

Keynes answered the "Treasury View" in a series of articles supporting Lloyd George, one of which, entitled "Can Lloyd George Do It?" (with Hubert D. Henderson), appeared in the Nation and Athenaeum in early 1929.[29/] In this article Keynes modified his 1924 stand on public works spending slightly. His key point was that expanding bank credit to private investors, under the circumstances then prevailing in England, might lower the rate of interest and lead to an adverse balance of payments. Government spending could safely alleviate the gold outflow problem. Keynes still held that "...the Bank of England should loyally co-operate with the Government's programme of capital development, and do its best to make it a success. For, unfortunately, it would lie within the powers of the Bank, provided it were to pursue a deflationary policy aimed at preventing any expansion in bank-credit, to defeat the best-laid plans and to ensure that the expenditure financed by the Treasury *was* at the expense of other business enterprise."[30/] (Keynes' italics)

---

29/ Readers familiar with Keynes' Economic Consequences of the Peace which castigated Lloyd George may find Keynes' new position somewhat curious. Keynes explained that, "The difference between me and some other people is that I oppose Mr. Lloyd George when he is wrong and support him when he is right." Harrod, p. 396.

30/ See Keynes, Essays in Persuasion (New York: Harcourt, Brace and Company, 1932) pp. 125-6.

The Treasury (at the time, Winston Churchill was Chancellor of the Exchequer) reacted to the support for Lloyd George's employment schemes in an unsigned contribution to a White Paper, "Memorandum on Certain Proposals Relating to Unemployment." The Treasury reiterated its views that increased Government borrowing to pay for public works merely reduced funds available for private investment.

Keynes responded (Nation and Athenaeum, May 1929) with an article entitled, "The Treasury Contribution to the White Paper," outlining how the Government might pay for additional expenditures without more taxation. This time he noted that "(1) cut in foreign investment; (2) cut in the dole; (3) increase in government revenues resulting from an increase in national income; (4) increase in profits, part of which will be saved; and (5) increase in wage payments, part of which will be saved"[31/] could supply the finance for the increase in Government spending, but he could still not count out bank credit as an initiating factor.

Keynes' views on Government spending to relieve unemployment were given a more influential forum when he was named a member of the Macmillan Committee in 1930. He was the dominant force on the Committee, delivering his opinions both as a witness (for five consecutive days) and as a critic. The change in his views here had less to do with financing the

---

31/ See Herbert Stein, The Fiscal Revolution in America (Chicago: The University of Chicago Press, 1969), p. 483.

Government deficit than with the necessity of creating it. He had previously noted that Government expenditures might be necessary (to stimulate employment) if increased private investment led to a gold outflow. During the course of the Committee hearings, he noted Government spending might be required if business confidence had been shaken so much by a slump that a large reduction of interest rates might not stimulate it (a forerunner of his interest-inelastic investment argument).32/

An article by R. F. Kahn was the key to Keynes' ability to prescribe increased Government expenditures without regard to the financing.33/ The mathematical formulation of the multiplier developed by Kahn indicated that the increased taxes and saving generated by the Government-induced income increase would be just enough to cover the financing of the deficit.

Before employing this argument in the General Theory, Keynes developed it to some extent in his 1933 pamphlet, The Means to Prosperity. Harrod notes that:

> We begin here to get the first inkling of an idea, more radical than anything recommended so far, that the Chancellor of the Exchequer should pump in additional purchasing power, not only by financing public works through loans, but also by remitting taxation without reducing current expenditure. This is almost 'deficit finance' in the full sense. Keynes

---

32/ Ibid., p. 145.

33/ R. F. Kahn, "Home Investment and Unemployment," Economic Journal, 1931.

> proposed to raise a loan of £60 million to finance public works on the one hand, and on the other hand to remit £50 million of taxation at the expense of the Sinking Fund. This reference to the Sinking Fund just - only just - made the project appear respectable.[34]

Kahn's refinement of the multiplier and Keynes' extension of the Pigovian cash balance concept into a liquidity preference framework enabled Keynes to move money to the background of his analysis and shift Government investment to the fore. Even in the General Theory, however, Keynes continued to recognize the strong potential for fiscal crowding out by government spending unaccompanied by monetary expansion.[35]

## Conclusion

The crowding out of private expenditures by fiscal policy actions has been a subject of interest to economists since Adam Smith. Smith and most other classical economists thought Government spending did not augment private spending under full-employment conditions, while some others, such as Malthus, believed a short-run demand deficiency could be eliminated by increased Government spending.

The Malthusian argument was not strongly revived (by economists) until the Keynesian era. During much of the period from Malthus to Keynes, analysts emphasized that Government spending unaccompanied by monetary expansion tended

---

34/ Harrod, p. 441-42.

35/ Spencer and Yohe, pp. 16-18.

to crowd out private expenditures. Keynes adhered initially to the classical argument, but eventually downgraded the monetary expansion "rider" in order to emphasize the necessity of expanded Government spending as an anti-deflationary measure.