8. Do budget deficits 'crowd out' private investment?

The present worldwide recession is proving unusually stubborn. Large reflationary packages, involving cuts in taxation and higher public spending, have been announced in several leading Western economies, but the recovery so far has been fitful and uncertain. Accompanying the sluggishness of activity have been large public sector financial deficits, particularly in the United Kingdom, the United States and West Germany. These deficits were largely caused by the recession (as it has cut tax receipts), but at the same time they are seen as serving the benign function of combating the weakness of spending (because the deficits represent a demand injection into the economy).

It may be thought unorthodox to argue that the deficits – or, more correctly, the deficits in conjunction with the strategies adopted to finance them – have done nothing to abate the recession. But the argument is not difficult to make. The key point is that extra spending by public authorities has been offset by reduced spending by companies and individuals. The more that governments have kept up their expenditure, the harder it has been for the private sector to carry out its investment and consumption plans. The mechanisms involved are not particularly complex and should be easy to understand, but their implications for economic policy are drastic and sometimes overlooked.

First, large public sector deficits, when financed by debt sales to the general public, deter private investment. If the government sells bonds to non-bank private agents, it reduces their money balances and drives up interest rates. These higher interest rates lead industrialists to reconsider some of their projects and therefore crowd out investment that would otherwise have taken place. This 'crowding out' effect has been much discussed in the United States recently, but it is not a new idea.

Indeed, it closely resembles the pre-Keynesian 'Treasury view' which was fashionable in Britain in the 1930s. The Treasury in those days always resisted demands for deficit financing on the grounds that the money the government did not raise in tax revenue would have to be raised by borrowing, with the same net effect on demand. Higher public spending would merely pre-empt resources which would otherwise have been utilized by the private sector. This apparently hard-faced attitude had been formed by experience of public works programmes in the 1920s. The Treasury found that, once these came to an end, there was a renewal of the initial problem, a lack of genuine jobs in private industry.

Old controversies can be tedious. In the 1930s the Treasury view was obviously misplaced because, with so many resources lying idle, the danger of less activity in one place because of more activity in another was minimal. The Treasury could have safely financed deficits by printing money. The result of the expansion in the money supply would have been to bring idle resources back into employment, not to push up prices. But Keynes never denied that in other circumstances 'crowding out' could be important.

More fundamentally, no one has ever doubted that, *with a given money supply growth rate*, a higher level of public debt sales must result in a lower level of bond issues by the private sector. Associated with the reduction in bond issues there is likely to be a reduction in capital spending and, in due course, less demand for labour. It would be rather brave to pass judgement here on the comparative merits of public spending and private investment, a question which is, after all, rather large. But the 'consensus' is that private investment is 'something we all need', 'a national priority' and 'essential for our survival'. Enthusiasm for public spending has, at any rate in the recent past, been less noisy.

Secondly, large sales of public sector debt induce higher savings by the personal sector and result in less consumption. The abnormally high level of personal savings found in the advanced economies this year can be largely explained in this way. It is interesting, for example, that the greatest departures from traditional savings behaviour have occurred in West Germany and the United Kingdom, which also have the largest public sector deficits (in relation to national income) of the major Western economies. In the first quarter of 1975 individuals in the United Kingdom saved 14.2 per cent of their disposable incomes and in the second quarter they saved 13.4 per cent. Throughout the 1960s the savings ratio averaged well under 10 per cent. Even in 1973, which at the time was thought to be an exceptional year, the savings ratio was 11.3 per cent. Much the same pattern is to be found in West Germany, although the level of savings has been consistently higher, with the savings ratio around 17.5 per cent this year. If people save more, they have less available to spend on consumption goods. The drop in demand for output is eventually reflected in the demand for labour and so counteracts the effect on employment of the public sector deficit.

Why should large public sector deficits prompt higher savings? The basic reason is the high interest rates which are inevitable if the government denies itself the easy option of financing its deficit by increasing the money supply. Most obviously, high interest rates give a good income to savers and affect the financial system profoundly. They make borrowing from banks and hire purchase companies more expensive, and encourage repayments of debt. (Note there is another, less noticed way in which they make saving worthwhile, as emphasized by Keynes in *The General Theory*. If interest rates are above their long-run level, the holder of fixed-interest public debt should make good capital gains when they come down.)

Although the level of interest rates is probably the best explanation of the recent financial behaviour of the personal sector, something of a controversy has developed over other possible influences. A thought-provoking suggestion was made in the Morgan Grenfell's latest *Economic Review*, edited by their economics director, Mr John Forsyth. The review argued that consumers try to keep their holdings of liquid assets in line with personal disposable income, because they need to have enough money or money-like assets to finance their transactions. If inflation is proceeding rapidly at say, 20 per cent per annum, they need to add 20 per cent to their existing holdings of liquid assets. Saving is sustained at a high enough level to ensure that this takes place.

The strands of the argument may now be brought together. If the government commits itself to a money supply target, public sector deficits and fiscal reflationary action have no further effect on economic activity. As part of a strategy to ignite recovery, they are more or less futile. They do virtually nothing to pull economies out of recession, and their only true effect is to alter the balance between the public and private sectors. Higher public expenditure, paid for by long-dated bond issuance, 'crowds out' private investment and causes higher personal savings. There is no positive effect on demand and no benefit to employment.

The refusal of Western economies to pick up despite massive doses of Keynesian reflationary 'action' can be largely explained by the greater awareness of monetary aggregates in the mid-1970s. In the 1960s central banks sometimes seemed to have no rationally formulated policy at all, apart from day-to-day marketry. But – to the extent that central banks had a policy – it was to maintain stable interest rates and allow the quantity of money to adjust to the economy. In that context extra government spending or lower taxation spilled over into the money supply and did stimulate economies. Now that the emphasis of monetary policy has changed, partly because of the lessons of the inflationary boom of 1971–73, fiscal policy is being neutralized by money supply responsibility. In these new circumstances reflating by fiscal means is like pumping air into a tyre with a puncture – the puncture being massive sales of government bonds to the non-bank public.

The argument can be taken a stage further. Governments reject calls for immediate massive cuts in public spending or sharp increases in tax rates on the grounds that they would deflate demand. The advice of a conventional 'Keynesian' economist would be that such steps would substantially aggravate unemployment and cause a needlessly severe cut in output. But no such consequences follow. Fewer bond sales would ensue, lowering interest rates and promoting both investment and consumption. If accompanied by the appropriate monetary measures, fiscal restraint need have no unfavourable effects on demand and employment.

Of course, there would be adjustment difficulties. If public sector employees are laid off as part of an economy campaign, they have to find jobs elsewhere. This takes time because of unavoidable labour market frictions, even if the demand is there. These difficulties give a warning against abrupt changes in fiscal policy. But they do not weaken the essential argument. In any case, difficulties of a different kind arise if public expenditure is uncontrolled and the money supply is held back: private sector employees are laid off and have to search for jobs in the public sector.

These qualifications need not be overdone. It is at last becoming clear that the coincidence and persistence of massive deficit financing with severe recession in most advanced economies signal the failure of fiscal policy. The present situation is the *reductio ad absurdum* of 'Keynesianism' – where Keynesianism is taken as the belief that an exclusive reliance can be placed on public spending and tax rates to control the economy. This belief, which never had any authority in Keynes's written work, is now being battered to death against a monetary brick wall.