Government, the private sector, and "crowding out"

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Sterling's lessons for the world
How public spending 'crowds out' the private sector
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As world economic recovery continues, there is in many countries growing concern lest productive investment be 'crowded out' by public expenditure. Here the two economists who have brought the issue to the attention of the public in America explain their view of how 'crowding out' occurs.

Government, the private sector and 'crowding out'

Karl Brunner and Allan H. Meltzer

The growth of government in all western countries is a remarkable phenomenon of our time. The growth is not adequately described by measures commonly employed such as the share of output absorbed by government or the share of national income taken by taxes. Large and persistent budget deficits force adjustments on the capital market and on banks. A wide range of government policies and regulations force enterprises to choose less efficient production techniques. Frequent changes in the 'rules of the game', and arbitrary decisions and interpretations of existing rules reduce freedom and efficiency, raise costs and divert resources from socially productive activities to negotiations or bargaining with government agencies about the interpretation of regulations or their specific application. As the size of government grows and the regulations become more detailed, and more arbitrary, uncertainty about the future increases. Long-term investment is deferred, or deterred, independently of the efforts occurring on the capital and labour markets.

The role of government, its size and relative inefficiency, is a central political and intellectual issue of our time. The citizen struggling against the bureaucracy to obtain answers or service recognises the issue and becomes aware of his loss of freedom and the gain in the power and influence that the state wields. Scholars, however, have not discovered the conditions fostering the explosive growth of government budgets, persistent deficits, the controls and regulations that spread into the details of most people's daily lives. A growing number of able scholars now work on these issues, so we are likely to learn more about the forces shaping these social and political trends in the next five to ten years.

Fortunately, we need not wait for answers to understand the consequences of the trend. When more labour is hired by government, the efficiency with which labour is used declines, and the trend growth of per capita output falls. Frequent erratic and arbitrary changes in the 'rules of the game' not only absorb personnel in rule making, interpretation and adjudication but also divert the attention of skilled personnel in the private sector from planning for the future to lightening present burdens. Rewards increase for those who are able to negotiate more favourable terms or reduce some onerous burdens of regulation and control. The greater are the rewards gained from knowledge of regulation and skill at negotiation, the more the intellectual resources of the country are drawn to occupations that are privately productive and socially wasteful. A rising government debt adds to the problems of the private sector by 'crowding out' private capital.

One effect of government controls is that the growth rate of output declines and the private sector declines, even in the absence of extensive nationalisation. As viewed by the public, the private sector fails to provide rising output per man and higher standards of well being.

Reasons for 'crowding out'
The Shadow Open Market Committee was founded by the two authors in 1973 to discuss the consequences of economic policies and to propose alternatives. In discussions, position papers and policy statements during the past two years, the committee has directed attention to the implications of 'crowding out'. The Wall Street Journal brought the issue to the attention of a larger public, and the discussion has expanded to hearings before committees of the Congress and in the financial press. Although 'crowding out' is but one of the issues raised by the growth of government, it has been a main issue in the recent discussion, and
To Future Generations, Security

Social welfare is a subject of serious consideration in most modern societies. Man in the twentieth century accepts his responsibility to bequeath to the next generation a society better than his own. Daiwa Bank is not unique in accepting this responsibility, but Daiwa is unique in making acceptance of this role in society an integral part of their banking service.

Daiwa is the only Japanese city bank to combine banking and trust business. Daiwa is thus a fully integrated banking institution, comprising banking, international financing, trust, pension trust, and real estate business. This integration is part of our effort to fulfill our social responsibility consistent with society's needs in a contemporary environment.

A reader conditioned by the Keynesian heritage may recoil at the idea that expansive fiscal measures, adopted by a government of good intentions, can lower privately produced output, the share of that output absorbed by consumers and private investors, the amount of capital per worker, and the future standard of living.

The story popularized by Keynesian thinking of a generation ago and revived in recent discussions by Cambridge economists reaches none of these conclusions. In their description of the multiplier process, increased government spending increases output by employing previously unemployed men and machines. The public sector deficit is spent, received, spent and re-spent. Income, output and total spending expands by a multiple of the initial stimulus provided by government. The increase in income is divided between private spending, saving and taxes paid to government. The rise in saving finances the accumulation of the government debt issued to finance the deficit. Increased tax collections, and reductions in payments for income maintenance, reduce the government's budget deficit as income increases.

A fundamental relation from the national income accounts describes the outcome more fully. Students of economics learn that observed (realized) saving, investment, government spending and net tax revenues are linked in a definite way by the saving-investment statement. The statement says:


Household savings and net foreign borrowing finance the government deficit and any excess of private investment spending over business saving. If private saving rises by as much as the deficit, the other items in the equation are unaffected. This is the traditional Keynesian view.

The apparent simplicity of the process and the pseudo-realism brought to the description of economic life help to explain the wide appeal of the Keynesian view. It is easy to tell stories that illustrate the process by which increases in spending produce further increases. Inventories are reduced, so they must be replaced. New orders add to the demand for output at factories, further increasing employment incomes and spending. For some inexplicable reason producers do not anticipate increased spending, and consumers do not anticipate increased incomes and increased demands for their services. The managers of private firms cannot remember how the process works, so they are surprised each time it is renewed. Since firms do not force the future increases in spending, they do not raise prices in the face of increased spending. Nor do they anticipate the
increased spending by building inventories. Since workers are surprised by the increased employment, they do not raise wages.

As the story is usually told, only the government remembers how the process unfolds and anticipates the outcome. The reason should be clear. If workers, producers and consumers are purposeful, thinking beings who learn from the past and anticipate the future, much of the appealing simplicity of the Keynesian story is lost.

The Keynesian story may seem most plausible and even reasonable in 'Keynesian economic contexts', situations exhibiting many idle resources, substantial unemployment and extremely low capacity utilisation. An increase in government expenditures, in these circumstances, cannot fail to raise private output and exercise the usual multiplying effect. The story remains incomplete, however, and omits important qualifications. To accept the simple multiplier explanation in disregard of crucial facts requires an almost religious belief.

Among the important omissions are the roles of interest rates, the price level, expectations of the price level and the repercussions of the government deficit on the capital markets. Allowing for these responses makes the description of the multiplier process much more complicated and much less routine. Resourceful individuals look ahead as well as behind, learn from past mistakes and anticipate future costs and prices.

Even Keynesian analysis has long recognised the validity of some qualifications. Most economists agree that the deficit raises interest rates, and the rise in interest rates reduces private spending. The general acceptance of this point means that there is no longer any doubt about the possibility of 'crowding out'. The possibility is dismissed, however, in Keynesian analysis by assuming that the response of private spending to interest rates is relatively small. Deficit spending adds more to output and private spending than is removed by rising interest rates. The net effect is an expansion of output and employment.

Nowhere in the typical Keynesian discussion is there any effect on prices or any anticipation of a future effect. Rising prices during periods of unemployment are regarded as an abnormality, an occurrence that cannot be explained by economic theory.

The problem lies not only with the Keynesians' economic theory but with their view of man. The first efforts to reduce unemployment and raise incomes by increasing government spending in the 1930s may have produced price and output changes that were unforeseen or at least not clearly anticipated by consumers and producers. Decades of countercyclical policy have removed many of the uncertainties about the long-term consequences of government policies. Keynesian economists may explain that there is no reason for prices to increase in periods of unemployment and idle capacity, but common observation everywhere do not support them. Nor do the attempts to make their argument come true by relying on controls, guideposts, income policies and the like, increase the credibility of their argument.

Purposeful, rational men recognise that at several points the simple Keynesian theory is in unmistakable disagreement with the facts. The economy does not follow the hypothetical sequence in any simple or regular way. Efforts to restore full employment do not end with unchanged prices or rates of inflation but most often with higher prices and higher rates of inflation. Efforts to embellish the simple story by introducing a trade-off between inflation and unemployment have left a heritage of inflation, an increase in the size of government relative to the private sector, slow growth of output and, at present, more unemployment.

There is an alternative view. The alternative view treats the government as a buyer of goods and services and an issuer of debt operating in the markets for goods, labour services and securities. Purchases of goods and labour affect both prices and output. Debt issues affect interest rates and prices on the equity market. Government debt must be absorbed in private portfolios.

The government is not the same as any private trader. Government securities denominated in domestic currency units are free of default risk, since governments can tax and print money. But these differences between government and private purchasers of goods, services and securities do not create a presumption that prices respond less to government purchases than to private purchases. The government competes with private purchasers. Increases in demand raise prices independently of the source of the increase. It should surprise no one that the response of prices and price anticipations to government spending, neglected in simplified Keynesian analysis, is the mechanism by which crowding out occurs. Since short and long-run crowding out differ in many respects, they are discussed separately.

Short-run crowding out
The most important determinants of short-run crowding out are:

1. the response of the price level to changes in output;
2. the response of the demand for aggregate output to changes in the price level;
3. the speed with which anticipations about future prices and wages respond to policy changes and observed price changes;
4. the effects of capital market adjustments on the demand for output.

If anticipations are fixed and do not respond to events
output and output per man declines.

The same result can be described as the outcome of decisions made by participants in the capital market. If the government sector's demand for output is held constant, the increase in prices reduces the real value of assets and reduces the expected rate of return. These changes in relative prices reduce the demand for private output and the expected rate of return. The government sector's demand for output is held constant, the increase in prices reduces the real value of assets and reduces the expected rate of return. These changes in relative prices reduce the demand for private output and the expected rate of return.

It is tempting, as in the 1930s, as an example of the Keynesian theory of the income determination of prices. The facts are observed in a variety of countries during the period of depression and recession. The rise in prices, mainly a response to monetary policy, is not large enough to eliminate the effects of restrictive fiscal policies. The rise in prices had positive effects on output and employment and contributed to the recovery.

A limiting case of a different kind occurs in countries where the government sector's demand for output is held constant. In such a country, the rise in prices is a response to the change in relative prices. The rise in prices increases the expected rate of return.

The outcome is in many ways an opposite effect. Complex rates and regulations absorb the effects of changes in the demand for output. The government sector's demand for output is held constant, the increase in prices reduces the real value of assets and reduces the expected rate of return. These changes in relative prices reduce the demand for private output and the expected rate of return. The government sector's demand for output is held constant, the increase in prices reduces the real value of assets and reduces the expected rate of return.

When resources are idle, the typical short-run response to a fiscal policy is to increase government spending. The rise in prices reduces the effective demand for government spending. Increasing government spending is accompanied by a rise in prices. The rise in prices reduces the effective demand for government spending. Increasing government spending is accompanied by a rise in prices. The rise in prices reduces the effective demand for government spending. Increasing government spending is accompanied by a rise in prices. The rise in prices reduces the effective demand for government spending.

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The same result can be described as the outcome of decisions made by participants in the capital market. To the purchaser of securities, government bonds, corporate bonds, mortgages, equities and other claims to real capital are alternative means of holding assets. Each must compete for a place in portfolios. The more private wealth owners, in the aggregate, use current real savings to purchase government securities, the less they have available to finance the accumulation of additional private capital. Private securities are crowded out of portfolios and replaced by government securities. If real rates of interest rise in response to new issues of government securities, private investment declines. The decline in private investment and the absorption of real savings to finance the public sector deficit are different aspects of long-run crowding out.

The saving-investment relation, introduced above, shows us that unless persistent budget deficits are financed by additions to private saving or foreign purchases, private investment falls. The share of income saved in most countries does not change greatly from one decade to the next. Under the dollar standard, foreigners financed a large part of the United States budget deficit from 1965 to 1971 by acquiring US government securities. This experience is extreme, not typical, and is not likely soon to be repeated. A persistent deficit to finance rising public expenditures cannot be expected to generate increases in the amount of real saving at full employment or in foreign purchases of domestic debt. A persistent deficit concentrates pressure on private investment.

In the long-run persistent deficits finance growth in the relative size of the public sector at the expense of private capital formation. Long-run crowding out occurs in three ways. First, full adjustment of prices, wages and anticipations at an unchanged level of full employment output means that increases in the share of output absorbed by government are achieved by reducing private absorption. Second, reductions in accumulation of private capital lower the growth rate of output produced by the private sector. Third, absorption of labour to produce government services reduces the output of the private sector by re-directing the labour force.

Reduction in the output of the private sector could, in principle, be offset by the increased output of the public sector. The result would be a change in the ownership of productive capital and in the employment of labour. The main effect of sustained deficits and a growing public sector would be replacement of privately produced output by the output of the government sector.

It does not happen. The budgets of most western countries do not show public investment in productive capital. Instead, there are loans or subsidies to enterprises that earn no profit or suffer large losses. Private saving is directed, in this case, toward enterprises that often do not earn rates of return equal to the interest on the bonds issued to finance the government budget deficit. Or, investment is used to increase 'prestige' as in the case of Concorde, the national airlines, steamship lines and other enterprises that operate at negative rates of return. These enterprises direct material, skilled labour, and capital toward less productive uses than the private output that is crowded out. The list of such enterprises can be expanded by every knowledgeable reader.

Absorption of labour by the government does not substitute public output for private output of equivalent value. Much public employment has the opposite effect. Complex rules and regulations absorb the time of civil servants and create demands in the private sector for lawyers, accountants, negotiators and clerks to keep abreast of the rules, to fill out the forms and hopefully to obtain more favourable interpretations than competitors have obtained.

Employment is generated by this process, but much of the output produced by the employees has little value to society. More efficient output is crowded out, replaced by records, completed forms and administrative decrees that in the aggregate, subtract more than they add to wealth and to welfare.